Buffalo Law Review

Volume 57 | Number 5 Article 2

12-1-2009

Trust in the Shadows: Law, Behavior, and Financial Re-Regulation

Raymond H. Brescia
Albany Law School

BUFFALO LAW REVIEW

VOLUME 57 DECEMBER 2009 NUMBER 5

Trust in the Shadows: Law, Behavior, and Financial Re-Regulation

RAYMOND H. BRESCIA†

INTRODUCTION

In the deep throes of the Great Depression, in an effort to restore faith in America's economy, the Roosevelt Administration promoted, and Congress authorized, the development of voluntary codes of conduct to govern employment and manufacturing practices across hundreds of industries. Compliance with these codes allowed companies to display a "Blue Eagle" decal on the shop floor, in their shop windows, and anywhere else their employees might work or the general public might come across their products. This symbol announced to the world that an employer was "doing its part" for the national recovery effort and was a business worthy of consumer trust. This strategy was an effort by the Roosevelt Administration to restore consumer trust in the recovery effort, to spur consumption generally, and to promote the trustworthiness of firms engaging in fair practices in particular.[1] In this

---

† Assistant Professor of Law, Albany Law School.
 The author would like to thank Dan Ariely, Robert C. Ellickson, and Thomas Sander for their helpful comments on previous drafts of this piece. I am grateful also for the assistance of Mal L. Barasch in conceptualizing this work; for the research assistance of Joseph Barlette, Meredith Perry, and Ashley Smith; and for the support of my legal assistant, Fredd Brewer.

1. The so-called "voluntary codes" of conduct under the National Industrial Recovery Act turned out to be not so voluntary; their violation could result in criminal charges. *See* 15 U.S.C. § 703 (1934), *invalidated by* A.L.A. Schecter Poultry Corp. v. United States, 295 U.S. 495 (1935). As a result, the Supreme Court struck down the law on which the system of conduct codes was based, when it determined that Congress's delegation of legislative functions under the Act was unconstitutional and the codes did not have a sufficient nexus to interstate commerce. *See Schecter Poultry,* 295 U.S. at 499. Since the suggestion

way, the Blue Eagle served as a heuristic—a cognitive shortcut—that helped consumers show their support for the recovery effort by patronizing companies complying with the Blue Eagle program's codes.

Could this Depression-era technique—the use of the Blue Eagle or some similar, useful symbol—serve important ends today? Could it help restore consumer trust in the institutions and actors in the financial system so that such entities and individuals might earn consumer trust, and prove trustworthy? This Article is an attempt to explore these questions in the context of regulatory reform of the financial system and determine if similar strategies could be deployed to encourage both trust in, and more importantly, trustworthy behavior among, actors within that system.

At present, the United States faces a crisis of confidence not unlike that which plagued recovery efforts during the Great Depression.[2] One aspect of this crisis is the relative lack of trust in our financial institutions: the very institutions that helped to inflate a speculative real estate bubble, the collapse of which has brought about the greatest economic crisis in eighty years. Efforts to restore trust to the financial system are foremost on the agenda of the Obama Administration and Congress.[3] Without such trust, credit markets will remain weak, consumer confidence and spending will remain stagnant, and investors will seek the safety of low-yield savings mechanisms while eschewing

---

here—that the Obama Administration should develop a truly voluntary code of conduct for financial services institutions—would not suffer from the same defects, it is unlikely that it would not withstand similar constitutional challenges. For more information on the Blue Eagle program, see pp. 1439-40 & n.266.

2. The literature comparing the Great Depression to the current financial crisis is extensive. *See, e.g.*, Christina D. Romer, Council of Econ. Advisors, Presentation Before the Brookings Institution: Lessons from the Great Depression for Economic Recovery in 2009 (Mar. 9, 2009), *available at* http://www.brookings.edu/~/media/Files/events/2009/0309_lessons/0309_lessons_romer.pdf.

3. The Obama Administration has laid out what it has called a "new foundation" for regulatory reform of financial markets. *See* DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter *Obama Plan*].

riskier investments that stand a better chance of promoting job creation. The main vehicle for these trust-restoring efforts is regulatory reform. And the primary focus of this reform movement is an effort to rein in the shadow banking system: a complex web of financial institutions and transactions that developed and thrived in a deregulatory atmosphere.[4] Within this atmosphere, highly leveraged borrowing fueled the build up and collapse of the subprime mortgage market, which ultimately triggered the broader financial crisis.[5]

Restoring trust in the financial system will be no small feat. Philosophers and economists have long extolled the virtues of trust in all human endeavors, particularly economic ones.[6] Trust acts as a lubricant and reduces the transaction costs associated with economic conduct; its presence makes economic activity more efficient and permits actors to focus on wealth generation rather than wealth preservation. Reconstructing a regulatory regime that will foster the trust necessary to restart the economic engine will require an understanding of what generates trust. Yet the financial crisis was, in many respects, a product of too much trust: trust in economists' forecasts, in mortgage brokers and lenders, in assessments of the

---

4. Nouriel Roubini described the interplay between the shadow banking system and the risks inherent to it as follows:

> Last week saw the demise of the shadow banking system that has been created over the past 20 years. Because of a greater regulation of banks, most financial intermediation in the past two decades has grown within this shadow system whose members are broker-dealers, hedge funds, private equity groups, structured investment vehicles and conduits, money market funds and non-bank mortgage lenders.
>
> Like banks, most members of this system borrow very short-term and in liquid ways, are more highly leveraged than banks (the exception being money market funds) and lend and invest into more illiquid and long-term instruments. Like banks, they carry the risk that an otherwise solvent but liquid institution may be subject to a self-fulfilling and destructive run on its liquid liabilities.

Nouriel Roubini, *The Shadow Banking System is Unravelling*, FIN. TIMES, Sept. 22, 2008, at 9.

5. *See, e.g.*, Alan S. Blinder, *Six Blunders En Route to a Crisiss*, N.Y. TIMES, Jan. 25, 2009, at BU7 (describing, inter alia, the role of leverage and subprime lending in fueling the financial crisis).

6. *See infra* Part I.A.

benefits of homeownership, in ever-rising home values, in the Bernie Madoffs of the world, in the architects of complex financial instruments, and in credit rating agencies. Overarching these sentiments was a regulatory philosophy that placed faith in the financial market itself: a belief that the market, unchecked, would serve the ends of economic growth and financial innovation. This web of trust fostered predation, overconfidence and unregulated risk; it brought about financial ruin for many and has caused incalculable hardship across the globe. For all the talk of restoring trust in the financial system, the proper focus of such efforts must be the restoration not just of trust, but of trustworthiness. To accomplish one without the other would simply invite the same pathologies that helped bring about the current crisis.

An approach directed at restoring trustworthiness to the financial system will require an appreciation for what makes such a system—and the actors within that system—trustworthy. Such an effort is the modest goal of this Article: to assess the manner in which formal and informal institutions might promote greater trustworthiness, particularly in economic endeavors. This requires an assessment of how humans respond to internal and external forces, as well as formal and informal rules. This assessment borrows insights from a range of disciplines—psychology, sociology, and economics—and several different schools of thought, including Law and Economics, Behavioral Economics, and New Institutional Economics. It is an attempt to identify the role of law and legal institutions in promoting trust and trustworthy behavior, and suggest ways that such insights can inform any approach to re-regulating the financial industry in the wake of the financial crisis.

Insights from these disciplines and schools of thought teach us several things. First, in situations where there are only weak rules against cheating and little oversight to monitor such cheating, it is more likely that people will cheat. Second, when people are partnered with others in long-term relationships in which cooperative behavior can be developed, nurtured and rewarded, they are more likely to cooperate in the pursuit of mutually beneficial ends. Third, in situations with greater social distance between people, individuals are more likely to engage in rent seeking activity and act in a less trustworthy fashion towards each other. Fourth, in environments where cooperation is encouraged, either by actors communicating with each other or when directed to cooperate by outside agents, people tend to act in a more cooperative and trustworthy fashion.

What I hope to develop from these insights is a set of principles that can help inform efforts to restore trust and trustworthiness to the financial system. While I consciously sidestep any granular prescriptions for re-regulating that system, I hope these principles can help to inform that effort. Because human beings are limited in their capacity to process information, a major overhaul of the financial regulations, on its own, is unlikely to restore trust in that system on the ground, with the lay public. While I do not dispute that there is an obvious need for such an overhaul, I propose that regulatory agencies also develop a set of voluntary codes of conduct for financial sector firms. To the extent such firms follow these codes, they will be able to market this information to consumers in an easily communicated manner: in the same way the Roosevelt Administration utilized the symbol of the Blue Eagle to reflect compliance with codes of conduct across a range of industries.

With these goals in mind, this Article proceeds as follows. In Part I, I will provide an overview of the importance of trust in economic life generally, which will include a discussion of the interplay between trust and economic growth. I will conclude this part with a discussion of trustworthiness, including some thoughts on how to measure the presence of trustworthiness in a given community. In Part II, I will describe in detail the factors, introduced above, that encourage people to be either trustworthy or untrustworthy. In Part III, I discuss the interplay between trust and law, describing the complementary effect that legal institutions can have on fostering and sustaining trust: an important inquiry considering that present efforts to restore trust to financial markets tend to focus on shoring up the financial regulatory and legal infrastructure governing such markets. In Part IV, I analyze the different ways the trust generating factors outlined above tend to encourage cooperative behavior and can be utilized in the different areas in which financial regulation and re-regulation is needed. Finally, in Part V, I propose a way in which regulatory reform can instill a sense of trust in the financial sector that is founded on trustworthiness. To this end, I propose that the financial system adopt voluntary codes of conduct—and use a symbol similar to the Blue Eagle to signify compliance therewith—that can give assurances to regulators and, more importantly, the general public, that financial institutions are acting in ways that are trustworthy and deserving of trust.

I. TRUST IN ECONOMIC LIFE

A. *The Importance of Trust in Economic Exchange*

For centuries, economic theorists have recognized the importance of trust to economic exchange. In John Stuart Mill's *The Principles of Political Economy*, the author discusses the importance of trust and the "burthens" placed on society from the lack of trustworthiness:

> The advantage to mankind of being able to trust one another, penetrates into every crevice and cranny of human life: the economical is perhaps the smallest part of it, yet even this is incalculable. . . . Conjoint action is possible just in proportion as human beings can rely on each other.[7]

Nobel Laureate Kenneth Arrow has recognized that trust is essential to nearly all economic activity: "Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence . . . ."[8]

In terms of the importance of trust in the financial sector in general, and in bankers in particular, Adam Smith famously pronounced:

> When the people of any particular country have such confidence in the fortune, probity, and prudence of a particular banker, as to believe that he is always ready to pay upon demand such of his promissory notes as are likely to be at any time presented to him; those notes come to have the same currency as gold and silver

7. 1 JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY ch. VII, § 5, at 108-09 (Cosimo 2002) (1907).

8. Kenneth J. Arrow, *Gifts and Exchanges*, 1 PHIL. & PUB. AFF. 343, 357 (1972).

> money, from the confidence that such money can at any time be had for them.[9]

Similarly, and most recently, Niall Ferguson has argued that money itself is a form of trust:

> The intangible character of most money today is perhaps the best evidence of its true nature. What the conquistadors failed to understand is that money is a matter of belief, even faith: belief in the person paying us; belief in the person issuing the money he uses or the institution that honours his cheques or transfers. Money is not metal. It is trust inscribed.[10]

At present, there is no shortage of commentators concerned with the current need to restore trust to the financial system.[11] Earlier this year, President Obama laid out the issue succinctly:

---

9. 1 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 292 (R.H. Campbell et al. eds., Oxford Univ. Press 1976) (1776).

10. NIALL FERGUSON, THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD 29-30 (2008).

11. A wide range of actors, public and private, have stressed the importance of restoring trust in the financial system. *See, e.g.*, *The Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC Before the Subcomm. on Commerce, Trade, and Consumer Protection of the H. Comm. on Energy and Commerce*, 111th Cong. (2009) (testimony of Michael Barr, Assistant Secretary for Financial Institutions, Dep't of Treasury) ("We must restore honesty and integrity to our financial system, in order to restore trust and confidence."); *Enhancing Investor Protection and the Regulation of Securities Markets Before S. Comm. On Banking, Housing, and Urban Affairs – Part II*, 111th Cong. (2009) (testimony of Richard G. Ketchum, Chairman & Executive Officer, Financial Industry Regulatory Authority) ("Creating a system of consistent standards and vigorous oversight of financial professionals . . . which license they hold—would enhance investor protection and help restore trust in our markets."); Bill Bradley, Op-Ed, *Five Ways to Restore Financial Trust*, WALL ST. J., Feb. 19, 2009, at A19 ("Restoring trust in the financial system is the key to solving the current economic crisis."); Timothy Geithner & Lawrence Summers, Op-Ed., *A New Financial Foundation*, WASH. POST, June 15, 2009, at A15 ("By restoring the public's trust in our financial system, the administration's reforms will allow the financial system to play its most important function: transforming the earnings and savings of workers into the loans that help families buy homes and cars, help parents send kids to college, and help entrepreneurs build their businesses."); Remarks by Assistant Secretary Michael Barr on Regulatory Reform to the Exchequer Club (July 15, 2009) (as prepared for delivery), *in* Press Release, U.S. Dep't of the Treasury, http://www.ustreas.gov/press/releases/tg213.htm ("To rebuild trust in our markets, we need strong and consistent regulation and supervision of consumer

> We also need a strong and viable financial system to keep credit flowing to businesses and families alike. My administration will do what it takes to restore our financial system; our recovery depends upon it. And so next week, Secretary Geithner will release a new strategy to get credit moving again – a strategy that will reflect the lessons of past mistakes while laying a foundation for the future. But in order to restore our financial system, we've got to restore trust.[12]

Treasury Secretary Timothy Geithner has stressed the connection between the need for reform of regulation of financial markets and the restoration of trust to those

---

financial services and investment markets."); Citigroup Advertisement, *Confidence*, http://www.citigroup.com/citi/press/advertising.htm (last visited Sept. 22, 2009) (providing an advertisement explaining why people trust Citi and Citi's commitment to its clients); Stephen Green, Group Chairman, HSBC Holdings, Remarks Before the British Bankers' Association Annual International Banking Conference: Restoring Governance and Trust (June 30, 2009), *available at* http://www.hsbc.com/1/PA_1_1_S5/content/assets/newsroom/090630_speech_bba.pdf ("[R]estoring trust means getting back to the *raison d'être* of banking."); Remarks by the President on 21st Century Financial Regulatory Reform (June 17, 2009), *in* Press Release, The White House http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/ ("That's our goal—to restore markets in which we reward hard work and responsibility and innovation, not recklessness and greed; in which honest, vigorous competition is the system—in the system is prized, and those who game the system are thwarted."); Remarks by the President After Regulatory Reform Meeting (Feb. 25, 2009), *in* Press Release, The White House, http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-after-Regulatory-Reform-Meeting/ ("[T]o rebuild trust in our markets, we must redouble our efforts to promote openness, transparency and plain language throughout our financial system."); Press Release, Standard & Poor's, Standard & Poor's Commitment to Reform: Restoring Confidence in the Credit Markets (July 16, 2009), http://www2.standardandpoors.com/spd/pdf/fixedincome/SP_WSJ_OpEd_Ad.pdf_(explaining the changes Standard & Poor's has implemented in order to earn back the trust of their investors); Lawrence H. Summers, Dir., Nat'l Econ. Council, Remarks at the Peterson Institute for International Economics: Rescuing and Rebuilding the U.S. Economy: A Progress Report (July 17, 2009) (as prepared for delivery), *available at* http://piie.com/publications/papers/paper.cfm?ResearchID=1264 ("The President was clear from the beginning that these two tasks needed to be dovetailed—that confidence in our ability to rescue the economy depended on a sense of our commitment to reform and a vision for rebuilding.").

12. Remarks by President Barack Obama on Executive Compensation with Secretary Geithner (Feb. 4, 2009), *in* Press Release, The White House, http://www.whitehouse.gov/the_press_office/RemarksbyPresidentBarackObamaOnExecutiveCompensationSecretaryGeithner/.

markets.[13] There is broad agreement that this restoration of trust is critical at this time of great distrust in our financial institutions, where recent research indicates that only 22% of Americans trust the financial system.[14]

What, then, is trust: this essential—yet perhaps intangible—feature of economic life, the restoration of which seems essential to solving the present economic crisis? What follows is a discussion of the meaning of trust: how to define the term, how to measure it, and its importance to economic activity.

B. *Defining Trust*

While there are many elements of the term "trust,"[15] I adopt Frank Cross's "working definition" as my own: trust is "the voluntary ceding of control over something valuable to another person or entity, based upon one's faith in the ability and willingness of that person or entity to care for the valuable thing."[16] While there are many different forms

---

13. *See Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals–Part Two Before the H. Comm. on Financial Services*, 111th Cong. (2009) (testimony of Timothy F. Geithner, Secretary, U.S. Department of the Treasury) ("The reforms proposed in the Administration's plan are designed to strengthen our markets by restoring confidence and accountability, while preserving that tradition of innovation.").

14. PAOLA SAPIENZA & LUIGI ZINGALES, UNIV. OF CHI. BOOTH SCHOOL OF BUS. & THE KELLOGG SCH. OF MGMT., FINANCIAL TRUST INDEX (Oct. 19, 2009), http://www.financialtrustindex.org/resultswave4.htm (showing 22% of Americans surveyed trust the financial system).

15. *See, e.g.*, Lawrence E. Mitchell, *The Importance of Being Trusted*, 81 B.U. L. REV. 591, 596 (2001) (reviewing literature on trust from various disciplines).

16. Frank B. Cross, *Law and Trust*, 93 GEO. L.J. 1457, 1461 (2005) (footnote omitted); *see also* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1739-40 (2001) ("[Trust is] a willingness to make oneself vulnerable to another, based on the belief that the trusted person will choose not to exploit one's vulnerability (that is, will behave trustworthily)."); Angela L. Coletti et al., *The Effect of Control Systems on Trust and Cooperation in Collaborative Environments*, 80 ACCT. REV. 477, 481 (2005) ("[W]e consider *trust* to be one's perception of another's trustworthiness."); Mark A. Hall, *Law, Medicine, and Trust*, 55 STAN. L. REV. 463, 474 (2002) (("[Trust is] the *optimistic* acceptance of a *vulnerable* situation in which the trustor believes the trustee will *care* for the trustor's interests."); Sim B. Sitkin & Nancy L. Roth, *Explaining the Limited Effectiveness of Legalistic "Remedies" for Trust/Distrust*, 4 ORG. SCI. 367, 368 (1993) ("[N]early all research has at least implicitly accepted a definition of trust

of trust,[17] it comes in two basic types: affective trust and cognitive trust.[18] Affective trust is an emotional state and is not based on the costs and/or benefits of such trust or on a calculative assessment of the trustworthiness of another.[19] We can trust a spouse, a parent, or a good friend on an emotional level: i.e., practically without thinking. Cognitive trust, on the other hand, involves a conclusion based on a cost-benefit analysis of the thing that is at stake for the trusting, as well as an assessment of the likelihood that the trusted will behave in a trustworthy fashion given a range of factors, including: the trustee's history of trustworthiness; and the severity, accessibility, and effectiveness of the sanctions available to the trustor to rein in the trustee's behavior.[20] We run through a different set of calculations when we place our child in the care of another, our car keys in the hands of a valet, or valuable items in an office cubicle. Some call this "calculative" trust.[21] Some are less sanguine about such trust; when one "trusts" in the trustworthiness of another in such situations, one is merely taking a "risk," and taking a risk is not the same as trusting.[22]

Separating out each instance where one is applying affective or cognitive trust can be difficult, however. I can trust a neighbor on an emotional level to return a borrowed tool because we are friends, have many things in common, and generally share a world view. My decision to trust him is also a reflection of the fact that I believe he would not risk the loss of our friendship, the chance that he could borrow a tool in the future, or his reputation in the community as a trustworthy person if he were to take

---

as a belief, attitude, or expectation concerning the likelihood that the actions or outcomes of another individual, group or organization will be acceptable or will serve the actor's interests.") (citations omitted).

17. *See, e.g.*, Susan Rose-Ackerman, *Trust, Honesty and Corruption: Reflection on the State-Building Process*, 42 EUR. J. SOC. 526, 527-29 (2001) (describing different dimensions of trust).

18. *See* Cross, *supra* note 16, at 1463.

19. *See id.* at 1464-65.

20. *See id.* at 1465-68.

21. *See, e.g.*, Oliver E. Williamson, *Calculativeness, Trust, and Economic Organizations*, 36 J.L. & ECON. 453, 485 (1993).

22. *See id.*

advantage of my trust in him. "Because trustworthy behavior is very often a result of both internalized noninstrumental values and instrumental motives, it becomes in practice quite difficult to separate out calculative from noncalculative trust-relevant behaviors."[23]

Just as trust has many different features, one's *willingness to trust in another* is based on many different factors in every situation in which trust may be sought or called for. In this way, willingness to trust is contextual—varying not just with each individual, his or her prior experience with trusting generally, and in trusting in a particular individual or entity—but also with a range of instantiated elements present in each trust situation. As Russell Hardin has argued, "[t]rust is a three-part relation: A trusts B to do X."[24] Each of these parts is a variable in the trust equation. A can be more or less trusting generally, based on his or her experiences with trusting behavior in the past, or can trust a particular individual while having no faith in humanity in particular.[25] An individual who grows up in a bad part of town where predatory behavior is the norm and who has little experience of the benefits of trusting behavior may, nevertheless, trust a long-time friend. Others are deserving of trust in certain circumstances, and less so in others. A businessperson can be a pillar of the community in affairs of money, with a tendency to cheat on the golf course; a thief can be a loyal friend and spouse.[26]

---

23. Claire A. Hill & Erin Ann O'Hara, *A Cognitive Theory of Trust*, 84 WASH. U. L. REV. 1717, 1727 (2006).

24. Russell Hardin, *The Street-Level Epistemology of Trust*, 21 POL. & SOC'Y 505, 506 (1993).

25. *See, e.g.*, Thomas Gautschi, *History Effects in Social Dilemma Situations*, 12 RATIONALITY & SOC'Y 131 (2000) (showing one's history with trusting and untrustworthy behavior has an effect on that individual's willingness to trust in the future); Roger C. Mayer et al., *An Integrative Model of Organizational Trust*, 20 ACAD. MGMT. REV. 709, 728 (1995) (finding experiences with trust and breaches of trust will inform perceptions of the trustworthiness of others).

26. In Steven Soderburgh's cinematic remake of *Ocean's 11*, George Clooney's character, Danny Ocean, a high end grifter and con man, is accused by his wife, played by Julia Roberts, of being "a thief and a liar." Danny professes that "he only lied about being a thief," defending his reputation for honesty to his spouse regardless of his chosen profession. OCEAN'S 11 (Warner Bros. Pictures 2001), *available at* http://www.dailyscript.com/scripts/oceans_11.pdf.

C. *Trust, Social Capital, and Economic Growth*

While the theorists cited above have promoted the importance of trust to economic activity, how, on a practical level, is trust important to such activity? Most essentially, perhaps, trust reduces transaction costs because economic actors have to spend less time and money searching for legitimate economic partners and monitoring the behavior of such partners.[27] Provided the partner is trustworthy and upholds his or her part of the bargain, one spends less time enforcing compliance with prior agreements. In this way, actors can spend more time increasing wealth rather than guarding it.

> There is agreement that trust is important in a number of ways: it enables cooperative behavior; promotes adaptive organizational forms, such as network relations; reduces harmful conflict; decreases transaction costs; facilitates rapid formulation of ad hoc work groups; and promotes effective responses to crisis.[28]

We can see the harmful effects of too little trust in the current economic climate. The financial crisis, moving forward, has weakened trust generally in many economic endeavors. Banks, not trusting consumers to be worthy credit risks, have strengthened underwriting criteria and

---

27. ERIC M. USLANER, THE MORAL FOUNDATIONS OF TRUST 17 (2002) ("Trust helps us solve collective action problems by reducing transaction costs—the price of gaining the requisite information that [two potential trade partners] need to place confidence in each other. It is a recipe for telling us *when* we can tell whether other people are trustworthy." (citations omitted)). Coase classified transaction costs into four categories: search, information, negotiation, and enforcement. R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 390-92 (1937).

28. Denise M. Rousseau et al., *Not So Different After All: A Cross-Discipline View of Trust*, 23 ACAD. MGMT. REV. 393, 394 (1998) (citations omitted). Trust also has broader, non-economic payoffs as well:

> Trust promotes cooperation. It leads people to take active roles in their community, to behave morally, and to compromise. People who trust others aren't quite so ready to dismiss ideas they disagree with. When they can't get what they want, they are willing to listen to the other side. Communities with civic activism and moral behavior, where people give others their due, are more prosperous.

Eric M. Uslaner, *Democracy and Social Capital*, *in* DEMOCRACY AND TRUST 121, 122 (Mark E. Warren ed., 1999).

restricted much commercial and consumer lending.[29] Those same banks, particularly during the deepest days of the crisis in the fall of 2008, did not trust the balance sheets of potential lending partners and were reluctant to lend to one another.[30] Investors, lacking faith in the economy generally, are fleeing to such safe opportunities as treasury bills and federally insured savings accounts.[31] Consumers, nervous about the health of the economy and the safety of their own positions, are starting to save rather than consume.[32] This may be a healthy approach for those consumers on a microeconomic level, but with consumption down, the lack of trust weakens the ability of the economy to expand on a macroeconomic level, slowing attempts at recovery.

While recognizing the importance of trust to economic activity, a critical question to ask when testing, empirically, whether trust is essential to such activity, is how is the relative level of trust in a society measured? If trust is important to economic activity, one would expect to see areas in which there are higher levels of trust faring better economically than communities low in trust. In order to address this issue, one has to be able to measure relative levels of trust across communities.

One commonly accepted way to measure the presence of trust in a community is to review responses to the World Values Survey, a multi-nation study conducted every five years that asks thousands of participants throughout the world, among hundreds of other questions, the following: "Generally speaking, would you say that most people can be trusted or that you can't be too careful in dealing with

29. *See* Stephen Gandel, *Lenders Look Beyond Credit Scores to Gauge Who's a Risk,* TIME, Jan. 9, 2009, http://www.time.com/time/business/article/0,8599,1870450,00.html (explaining that lenders are going to less traditional methods of determining creditworthiness of borrowers).

30. *See* Carrick Mollenkamp et al., *Lending Among Banks Freezes,* WALL ST. J., Sept. 16, 2008, at A1 (explaining that despite efforts of central banks the Libor index showed banks' reluctance to lend to each other).

31. *See* Jeff Sommer, *Up 40%, but Still Feeling Down,* N.Y. TIMES, July 26, 2009, at BU4 (explaining that investors are turning to safer investments as it becomes more important to avoid big loses as opposed to making big gains).

32. *See* Jack Healy, *As the Recession Worsens, Consumers Save More and Spend Less,* N.Y. TIMES, Feb. 3, 2009, at B3.

people?"[33] Participants are asked to decide whether "[m]ost people can be trusted" or whether one "[n]eed[s] to be very careful" in dealing with others.[34]

Another common way that social scientists and others look at the level of trust within society and the extent to which trust manifests itself in levels of civic cooperation that both foster cooperation and increase trust, is to look at the relative level of "social capital" within a given society or community.[35] Social capital is manifest in the "social networks and the . . . norms of reciprocity and trustworthiness" associated with such networks.[36] Such networks and norms facilitate cooperation by generating feelings of mutual obligation towards other members of a network, encouraging information sharing, and conveying a code of conduct that carries sanctions for a network member's violation.[37] Communities that have high levels of social capital are better off economically and have lower

---

33. PIPPA NORRIS, DEMOCRATIC PHOENIX: REINVENTING POLITICAL ACTIVISM 149 (2002) (citation omitted). Though not a perfect gauge of trust to any extent, Norris believes "this item has become accepted as the standard indicator of social or interpersonal trust." *Id.*

34. *Id.* For background information and to analyze the data results from the 2005 survey and prior surveys, see JAIME DIEZ MEDRANO, WORLD VALUES SURVEY ASS'N, WORLD VALUES SURVEY V23 (2005), http://www.jdsurvey.net/downloads/wvs2005a_v20090901_spss.zip; and World Values Survey, www.worldvaluessurvey.org (last visited Oct. 29, 2009). A sampling of the data from 2005 shows that some nations, like Finland and the Netherlands, ranked very high in terms of individuals who felt that most people could be trusted, with respondents in those countries agreeing with that statement almost 60% of the time for Finland, and 45% of the time for the Netherlands. In that year, Iraqis agreed with that statement over 40% of the time, and respondents in the U.S., just under 40%. In countries like South Africa and Colombia, the percentage of individuals agreeing with the statement "most people can be trusted" was, not surprisingly, quite low: 19% and 15%, respectively. MEDRANO, *supra*.

35. On measuring social capital and trust, see, for example, Christiaan Grootaert et al., *Measuring Social Capital: An Integrated Questionnaire* 12 (World Bank, Working Paper No. 18, 2004).

36. Robert D. Putnam, E Pluribus Unum: *Diversity and Community in the Twenty-first Century*, 30 SCANDINAVIAN POL. STUD. 137, 137 (2007).

37. For an overview of social capital theory, see, for example ROBERT D. PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY (2000); and James S. Coleman, *Social Capital in the Creation of Human Capital*, 94 AM. J. SOC. S95 (Supp. 1988).

crime rates, while the residents of those communities report higher levels of life satisfaction.[38]

Unfortunately, there seems to be a great deal of disagreement over how to measure social capital. Some combine trust indicators, like the World Values Survey described above, with gauges of levels of civic participation, like the rates of involvement in civic groups such as bowling leagues and religious congregations, among other factors, claiming that such community involvement is both a proxy for and result of social capital.[39] Others argue that higher levels of social capital in communities that function well are a result of higher levels of trust in those communities generally. To these theorists, what is valuable to a community is not the extent to which its participants are involved in community groups, but rather, the general level of trust within that community.[40] Certainly, civic engagement can be both a product of trust—one that cares for and trusts other community members will be more willing to get involved in community activities—and can also produce trust: when one is involved in community activities, one gets to know one's neighbors or other group members better, which lowers social distance and generates higher levels of empathy and trust in others.[41]

---

38. *See* Michael Woolcock, The Place of Social Capitalism in Understanding Social and Economic Outcomes, http://www.oecd.org/dataoecd/5/13/1824913.pdf (providing an overview of benefits of social capitalism).

39. *See, e.g.*, PUTNAM, *supra* note 37, at 415-26 (describing Putnam's methodology for measuring social capital).

40. *See, e.g.*, NORRIS, *supra* note 33, at 156.

41. The interplay between trust and social capital has been described by Robert Putnam as follows:

> In the first place, networks of civic engagement foster sturdy norms of generalized reciprocity and encourage the emergence of social trust. Such networks facilitate coordination and communication, amplify reputations, and thus allow dilemmas of collective action to be resolved. When economic and political negotiation is embedded in dense networks of social interaction, incentives for opportunism are reduced. At the same time, networks of civic engagement embody past success at collaboration, which can serve as a cultural template for future collaboration. Finally, dense networks of interaction probably broaden the participants' sense of self, developing the "I" into the "we," or . . . enhancing the participants' "taste" for collective benefits.

If there is some economic benefit from having higher levels of trust and social capital in a community, as stated earlier, one would expect to see greater economic activity and growth in nations in which social capital and trust are high. Many studies attempt to analyze this question and most find a correlation between trust and growth. Indeed, "[t]hose societies richest in social capital are all established democracies with some of the most affluent postindustrial economies in the world."[42] A close analysis of the data reveals that trust appears to be the central variable generating growth, as opposed to simple levels of civic engagement.[43]

But the value of trust to growth cannot simply hinge on whether people trust, as the economic crisis has shown. The global economy did not want for trust. Rather, what we experienced was too much trust: trust in mortgage brokers, trust in investment banks, trust in credit rating agencies, trust in asset values, trust in investment advisors, etc. Tragically, such trust was too often met with a lack of trustworthiness, and predation and irresponsible conduct contributed greatly to the financial crisis. Therefore, a deeper analysis of trust and trustworthiness is required

---

Robert D. Putnam, *Bowling Alone: America's Declining Social Capital* (1995), *reprinted in* CULTURAL METEPHORS: READINGS, RESEARCH TRANSLATIONS, AND COMMENTARY 109, 111 (Martin J. Gannon ed., 2001). *But cf.* USLANER, *supra* note 27, at 128 (arguing civic engagement does not lead to greater trust); Dietlind Stolle, *Clubs and Congregations: The Benefits of Joining an Association, in* TRUST IN SOCIETY 202, 233 (Karen S. Cook ed., 2003) (finding higher trust within groups a product of self-selection: higher trusting individuals join groups rather than higher trust resulting from joining groups). On the importance of trust to the functioning of democratic governance generally, see Mark E. Warren, *Democratic Theory and Trust, in* DEMOCRACY & TRUST, *supra* note 28, at 310-43.

42. NORRIS, *supra* note 33, at 153.

43. *See, e.g., id.* at 156 ("Social capital is associated with socioeconomic development . . . but *this link appears to operate through social trust, not civil society.*"); Stephen Knack & Philip Keefer, *Does Social Capital Have an Economic Payoff? A Cross-Country Investigation*, 112 Q.J. ECON. 1251, 1283-84 (1997) (finding a relationship between trust and economic growth, but finding no evidence of relationship between social capital and such growth); Paul F. Whiteley, *Economic Growth and Social Capital*, 48 POL. STUD. 443, 453, 460 (2000) (using response to questions related to trust of others on World Values Survey from 34 countries from 1970 to 1992 and finding trust closely related to economic growth and performance during that period).

than one that equates trust, uncritically, to growth.[44] What the experience of the last decade appears to prove is not whether trust is essential to economic activity, but rather the extent to which trustworthiness is that essential ingredient to make economies function well. If that is the case, when asking whether we need to restore trust to the financial system, what we must really mean is whether we need to restore *trustworthiness* to that system. And if *that* is the case, the correct questions to ask are: to what extent can re-regulation restore such trustworthiness to the system; if it can, what would be the optimal way to do so?

Again, as stated earlier, the conclusion typically reached by these studies—that greater trust is equated with greater economic growth and prosperity—cannot tell the whole story. Indeed, as the economic crisis has shown, too much trust can be toxic. The lead up to the financial crisis was a failure of both too much trust and too much untrustworthiness that preyed upon that trust. Since that is the case, perhaps we have been looking at the wrong factor in Hardin's trust equation. Perhaps what we need to look at is not whether A trusts, but whether B is trustworthy: i.e., whether A's trust in B is misplaced, and what are the consequences of that misplaced trust.[45]

---

44. Of course, growth or income is not the only measurement of well-being in a society, but I will use this as a gauge of economic activity generally because it appears that at this critical economic juncture, restoration of trust and trustworthiness is essential to stave off the worst impacts of the current economic downturn, which have obvious broader social ramifications: displacement and foreclosure, job loss, and hunger, to name just a few. For alternative benchmarks for measuring development, see AMARTYA K. SEN, DEVELOPMENT AS FREEDOM 3-53 (Oxford Univ. Press 2001) (1999).

45. As Hardin also points out:

> Betrayal is, of course, not a failure of trust but a failure of trustworthiness. It is odd therefore that academic writings—both philosophical and social scientific—focus heavily on trust rather than on trustworthiness. Indeed, most writings on trust tend to say things that, as noted earlier, would make easy sense if applied to trustworthiness but that make less sense when applied to trust. If such statements make sense for trust at all, it is only indirectly through the causal connection that trustworthiness begets trust.

Russell Hardin, *Conceptions and Explanations of Trust*, *in* TRUST IN SOCIETY, *supra* note 41, at 32; *see also* Cross, *supra* note 16, at 1530. Cross, recognizing the potential to abuse trust, notes that "more trust is not always preferable to less trust. The key is distinguishing when trust is undesirable." *Id.*

D. *Trust and Trustworthiness*

The first variable in the trust equation—whether A trusts—cannot be the lynchpin between trust and economic growth. It is apparent from the causes of the present financial crisis that what matters more to economic growth and sustainability is not whether A trusts, but rather whether B is trustworthy in a particular context. Trustworthiness then seems to be the essential element in the economics of trust.[46] If that is the case, what are the essential elements of trustworthiness, and if we are to bring a more robust regulatory structure to the financial system, can we tailor such a structure to enhance trustworthiness so that trust in the financial context is sensible and does not invite predatory conduct? [47] Before I turn to this issue, I will address whether trustworthiness is itself a measurable variable.

In one study, researchers working with a group of undergraduates attempted to study the correlation between responses to participants' survey questions regarding the extent to which they might trust others, and their own level of trustworthiness.[48] Working from the participants' responses to the National Opinion Research Center's General Social Survey question, "Generally speaking, would you say that most people can be trusted or that you can't be too careful dealing with people?"[49], the researchers asked the subjects to participate in a trust game involving the

46. It also seems to be the essential element in the *morality* of the trust-trustworthy nexus. *See* Jane Mansbridge, *Altruistic Trust, in* DEMOCRACY AND TRUST, *supra* note 28, at 290 ("Because trust is a probabilistic expectation, it is a belief. We do not in general consider beliefs moral or immoral. Therefore trust is neither moral nor immoral. In an interaction in which trust means only prediction, the moral virtue is trustworthiness, not trust.").

47. Trustworthiness has been defined as "an innate personal characteristic reflecting one's preference for upholding some social norm of behavior, regardless of economic incentives. In contrast, we consider trust to be one's perception of another's trustworthiness." Coletti et al., *supra* note 16, at 481 (footnote omitted).

48. Edward L. Glaeser et al., *Measuring Trust*, 115 Q.J. ECON. 811 (2000). These researchers were replicating in some respects previous research that sought to explore similar issues. *See* Joyce Berg et al., *Trust, Reciprocity, and Social History*, 10 GAMES & ECON. BEHAV. 122 (1995).

49. Glaeser, *supra* note 48, at 814.

exchange of money.[50] In this study, participants were matched in pairs and one was given a sum of money that he or she could keep or send to his or her partner in the study.[51] Any sum sent to the partner was matched by the researchers.[52] The recipient would then share what was sent with the sender by returning a portion of what he or she received.[53] Because the researchers matched what was ultimately sent to the recipient, the more money sent by the sender meant that the recipient had more money to send back to the sender.[54] At the end of the day, the sender could send nothing, and get nothing in return, could send a percentage of what was given him or her, or could send the maximum amount initially received.[55] Conceivably, provided the recipient was not sent a very small sum, he or she would send back half of what he or she received, which meant *both* came out ahead, instead of having the sender simply keep what was originally provided. Thus, through cooperation, both participants could benefit to the maximum amount if both parties cooperated and shared fully.

The results of the study revealed several findings which were not groundbreaking. First, when the parties did not know one another, it was less likely that they engaged in conduct likely to optimize the outcome for both.[56] When the participants were not of the same race or ethnicity, similarly, optimal outcomes were also less likely. These are disheartening results, for sure. But what the researchers also found, which might come as a surprise, was that the participants' answers to the question regarding whether people can be trusted said very little about the *sender's* behavior in the experiment.[57] That is, whether or not someone was trusting generally bore little relation to how much money the sender sent to the recipient. Rather, what did tend to correspond positively to participants' attitudes

50. *Id.* at 819-23.

51. *Id.* at 820.

52. *Id.*

53. *Id.*

54. *Id.* at 820-21.

55. *Id.*

56. *Id.* at 821 (the participants were undergraduates at the same university and some knew one another).

57. *Id.* at 822-27.

towards the trustworthiness of others was how much money the recipient sent *back* to the sender: returners sent back more if they believed others trustworthy.[58] In other words, what this study tended to show was that the extent to which one says one trusts others may, in fact, be a reflection of that person's trustworthiness. The more one says one trusts others, the more likely it is he or she will, in turn, act in a trustworthy fashion. According to the researchers, "[t]hese findings suggest that the standard trust questions may be picking up trustworthiness rather than trust."[59] The results "imply that the best way to determine whether or not a person is trustworthy is to ask him whether or not he trusts others."[60]

One example helps to prove the point that measurements of trust are likely also measurements of trustworthiness. Robert Putnam has drawn from data from the Internal Revenue Service that analyzed differing levels of tax compliance among the residents of different states in the United States to compare such levels to the relative levels of social capital within those states.[61] That research reveals that states with low levels of social capital, as measured by Putnam, who includes trust indicators within his social capital index, also have low levels of tax compliance.[62] The conclusions to be drawn from these findings are not readily apparent and may raise more questions than they answer.

Do such findings reveal the extent to which members of a given community know whether their neighbors file their taxes properly? Is this information neighbors tend to share with one another? Does a low level of trust within a given community signify that the residents of those communities are keen-eyed evaluators of their neighbors' trustworthiness? Does the extent to which they trust or do not trust correlate significantly with whether their neighbors comply with their obligations to pay taxes? Or is another explanation for this correlation possible: i.e., that

58. *See id.*

59. *Id.* at 833.

60. *Id.*

61. PUTNAM, *supra* note 37, at 347-49 (tracking IRS data on state-by-state tax compliance levels).

62. *Id.*

individuals who trust less are likely to act in a less trustworthy fashion by, for example, not paying their taxes? Is this correlation a function of the fact that individuals who do not trust their neighbors are less likely to behave in a trustworthy fashion for fear of being the only suckers who comply with a given norm or law?

The psychological and calculative forces at play in the decision to pay or not pay taxes are likely complex, and are probably at work in different ways for different people.[63] Regardless of the particular reasons people do not pay taxes, tax cheats are not trustworthy (at least in terms of paying their taxes). And those who are not trustworthy are probably less likely to trust others, either because they would not trust themselves to behave in a trustworthy fashion or they project this sentiment onto others. As a result, communities with a low level of trust among their members are also likely to include people who behave in a less than trustworthy fashion. Groucho Marx famously proclaimed that he would not join any club willing to have him as a member,[64] and Jerome Blattner—who seems to be famous simply for this quote—said that "a person who trusts no one can't be trusted."[65] Perhaps those who are untrustworthy themselves are likely to think of others as untrustworthy. What we may see at play here is the psychological principle of projection, through which an individual projects onto others the views he or she holds

---

63. *See, e.g.*, Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323 (1972) (viewing tax compliance patterns and applying a model similar to Becker's criminal compliance model to explain tax evasion); Dan M. Kahan, *Signaling or Reciprocating? A Response to Eric Posner's Law and Social Norms*, 36 U. RICH. L. REV. 367, 378-80 (2002) (discussing reasons for noncompliance with duty to pay taxes); Chester N. Mitchell, *Willingness-To-Pay: Taxation and Tax Compliance*, 15 MEMPHIS ST. U. L. REV. 127 (1985) (discussing how undetected tax evasion encourages others to not comply); Richard C. Stark, *A Principled Approach To Collection and Accuracy-Related Penalties*, 91 TAX NOTES 115, 116 (2001) (discussing reasons for noncompliance).

64. THE YALE BOOK OF QUOTATIONS 498 (Fred R. Shapiro ed., 2006), *available at* http://yalepress.yale.edu/yupbooks/qyd/ ("I do not care to belong to a club that accepts people like me as members.").

65. WorldofQuotes.com, Jerome Blattner Quotations, http://www.worldofquotes.com/author/Jerome-Blattner/1/index.html (last visited Oct. 28, 2009).

about him or herself.[66] Thus, indicia of trust may also serve as proxies for trustworthiness.

While I have discussed the importance of trust and trustworthiness to economic life, the connection between economic activity and lack of trust and trustworthiness is also fairly obvious. Where there is less trust and trustworthiness, there will be fewer economic transactions, cooperation is likely to be costly and rare and there will be less risk taking on the part of investors. This means firms are less willing to engage in research and development, and investors are less likely to invest in opportunities that might create jobs. Where there is little faith in the legal system to protect property rights or there are few investor protections, people will not invest money to improve land they might lose (instead, spending money defending their land), and investors are less likely to trust the system to police against fraud, insider trading, and other bad acts. This makes investors more reluctant to take risks with their capital; meaning it goes to less productive uses.

So what is it that makes people trusting or trustworthy? The following part addresses this issue, and attempts to develop a set of principles for fostering trust by asking what forces might generate trustworthiness.

II. LAW AND ECONOMICS, BEHAVIORAL ECONOMICS AND THE IMPORTANCE OF BEING TRUSTWORTHY

A. *Economic Behavior: An Open Debate*

Before turning to the issue of what makes people trustworthy, I will first discuss two schools of thought regarding the behavior of economic actors—how they respond to external, structural forces such as laws, sanctions and oversight and such internal forces like bias, honor, and reputation. Such a discussion can help inform policy discussions concerning how to advance financial regulation because these schools posit theories about the

66. On the psychological process of projection, see, for example, THE DICTIONARY OF PSYCHOLOGY 767 (Raymond J. Corsini ed., 2002), for the definition of projection; and MARIE-LOUISE VON FRANZ, PROJECTION AND RE-COLLECTION IN JUNGIAN PSYCHOLOGY: REFLECTIONS OF THE SOUL 1-25 (Open Court Publ'g 1995) (1978), for a discussion of the concept of projection generally.

manner in which human beings respond to such external and internal forces.

The first school of thought, Law and Economics, which is informed by neoclassical economic theory, posits that we should craft policy decisions with the assumption that all economic actors are rational in their decision making processes, free of irrational influences, and take into account a wide range of critical information before making decisions that impact their economic well-being.[67] The best policies are those that take this perspective into account and craft rules that help economic actors maximize their wealth.[68]

In contrast, behavioral economists believe that human beings are not always rational actors; instead, they make decisions based on a range of irrational forces: emotion, bias, imperfect information, overvaluation of their assets, and overconfidence in the correctness of their decisions.[69] Policies must take into account the potential pitfalls of these irrational forces and create the best "choice

---

67. *See, e.g.*, Richard A. Epstein, *The Neoclassical Economics of Consumer Contracts*, 92 MINN. L. REV. 803, 804 (2008) ("[T]he neoclassical conclusion [is] that competitive markets—markets with multiple, self-interested players on both sides, armed with relatively full information—will generate a mix of goods and services that is superior to those that can be generated with various forms of government regulation.") (footnote omitted).

68. The literature on Law and Economics is vast, to say the least. For some of the early and seminal works, see GARY S. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR (1976); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (7th ed. 2007). A close cousin to Law and Economics, the New Institutional Economics (NIE), takes into account the influence of institutions—which can be formal, like laws and constitutions, and informal, like norms—on human decision making. Many proponents of NIE would likely consider the sources of some of the forces described below as institutions worthy of study. For an overview of the NIE approach, see, for example, DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990); and Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 J. ECON. LIT. 595 (2000). For a comparison of the NIE approach with that of the Law and Economics movement, see RICHARD A. POSNER, OVERCOMING LAW 426-443 (1995).

69. For an overview of behavioral economics and its application in the legal context, see generally BEHAVIORAL LAW AND ECONOMICS (Cass R. Sunstein ed., 2000).

architecture" for individuals to make enlightened, wealth-maximizing decisions.[70]

What do these different schools of thought say about the causes of and cures for the financial crisis? Judge Richard Posner, a leader in the Law and Economics movement, argues that the behavior of both bankers and borrowers was entirely rational; it just led to unchecked systemic risk that now threatens the stability of the financial system.[71] Bankers looked at the short-term gains that could be gained by investments in the U.S. housing market and other sectors and pursued them aggressively.[72] According to Posner, this may have been the most rational course of conduct in the era of easy credit.[73] Some borrowers, on the other hand, were faced with the prospect of borrowing money to purchase homes that, it was believed, would continue to rise in value with little to no money down and with little investigation conducted by lenders of those borrowers' creditworthiness. Where a borrower would risk nothing on an investment such that he or she had everything to gain if the value of the asset increased, and nothing to lose if it decreased in value, the rational course of conduct in such a situation would be to jump at such an opportunity. These rational choices—by bankers and borrowers—ultimately led to the collapse of the system on a macroeconomic level; what was rational for individual actors tended to threaten the stability of the system as a whole. Despite the admitted failure of the deregulatory movement to rein in capitalism's worst excesses, or check what is argued to be rational microeconomic conduct that led to macroeconomic disaster, Law and Economics proponents now bridle at the thought of aggressive re-

70. For an application of behavioral economics principles in a range of policy areas, see generally RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008).

71. RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 75-112 (2009) (assessing causes of the financial crisis).

72. *See id.*

73. *Id.* at 83-85.

regulation of financial markets, preferring a "wait-and-see" approach.[74]

Behavioral economists look at the financial crisis as a failure, primarily, of information asymmetries and overconfidence.[75] Borrowers were unable to make informed decisions about the risky loan products to which they were tethered. Brokers exploited this lack of information as well as the overconfidence of such borrowers in the value of the assets that secured the loans: i.e., the homes those borrowers were purchasing with borrowed money. As a prescription for these forces, solutions to the financial crisis that are informed by behavioral economics focus on improved consumer education[76] and the promotion of a standard mortgage as the norm in the mortgage market, only to be departed from where borrowers have made informed decisions to pursue more complex financial instruments.[77]

Regardless of what vision of economic life holds true—that humans are rational or irrational—what follows is a description of research into what makes people trustworthy. What this research reveals is that some conduct might be entirely rational (for example, the decision to cheat where

74. *See id.* at 293, 296. Posner argues that it is "premature" to alter the regulatory framework and that "[r]eregulation, like reorganization, should wait." *Id.*

75. *See, e.g.*, Joe Nocera, *Poking Holes in a Theory on Markets*, N.Y. TIMES, June 6, 2009, at B1 (interviewing and discussing beliefs of respected market analyst Jeremy Grantham, who argues that the efficient market hypothesis led to a feeling of overconfidence in the market and its ability to correct itself leading to investors wrongly believing the crisis would solve itself; Mr. Grantham believes that behavioral economic theory is more applicable to actual markets); Robert J. Shiller, *It Pays to Understand the Mind-Set*, N.Y. TIMES, Mar. 29, 2009, at BU5 (claiming that the mind-set of investors, essentially over confidence, must be understood in order to fully understand the financial crisis); Richard H. Thaler, Op-Ed., *Mortgages Made Simpler*, N.Y TIMES, July 5, 2009, at BU4 (describing and concurring with current Treasury Department plans for simplifying mortgage process and options in order to help consumers make proper decisions and avoid disrupting economy in future).

76. *See, e.g.*, ROBERT J. SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT (2008).

77. *See, e.g.*, THALER & SUNSTEIN, *supra* note 70, at 133-38; Michael S. Barr et al., *Behaviorally Informed Home Mortgage Regulation*, *in* BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED 170 (Nicolas P. Retsinas & Eric S. Belsky eds., 2008).

there is little chance one will be caught), and other behavior entirely irrational (like believing that assets only ever increase in value). As the following discussion shows, like the different strands of trusting behavior, both emotional and cognitive, there are instances where humans behave both rationally and irrationally. We make decisions based on sensible and sober assessments of the risks involved in certain conduct, and, at times, we take plunges, act on whims and rely on our gut instincts, regardless of the risks associated with such decisions. We are impacted by the formal laws that bind our conduct, as well as internal forces like honor and external forces like gossip.

I turn now to a substantial body of research and literature on decision making and cooperation, most notably prisoner's dilemma games. I submit that this research reveals that at times economic actors behave rationally, and at times, irrationally: at times they react to external—both formal and informal—forces, at times to internal forces. That at times we cooperate when it is in our best interest to cooperate and we compete when it is in our best interest to compete, and vice versa. Perhaps economic conduct is, to paraphrase Yogi Berra's wonderfully profound description of baseball, ninety percent rational and the other half irrational.[78]

In analyzing the results of this research, I will focus on identifying the conditions that encourage people to act in a trustworthy fashion, as well as those conditions that tend to increase the likelihood that people will cheat, act in a non-cooperative fashion and engage in rent seeking. It is not necessary to align with a particular philosophical or theoretical camp when doing this, because all seem to have something important and relevant to say about human behavior and the best ways to channel such behavior to maximize utility, wealth and well-being.

Although there is no need to adopt any particular view of human economic behavior for a further discussion of the topic chosen, since this Article attempts to suggest the best regulatory approach to restore trust to the financial system, I will align myself with the emerging scholarship known as

---

78. *See* Joe LaPointe, *Berra, at 83: A One-of-a-Kind Common Man*, N.Y. TIMES, Apr. 16, 2009, at B13 (quoting Baseball Hall-of-Famer Yogi Berra, famous for his gritty play on the field and colorful turns of phrases off of it, as saying "Baseball is 90 percent mental and the other half is physical").

the "New Governance."[79] This scholarship attempts to integrate and synthesize different approaches from disparate theories in an effort to gain from the best insights that can be culled from such theories. As Orly Lobel has posited, such an approach, which she calls the "Renew Deal," "represents a maturation of legal thought":[80]

> Rather than oppositional, the Renew Deal aims for an appreciative positive stance, pulling together disparate ingredients and synthesizing elements from opposing schools of thought. Through new governance approaches, contemporary thinkers can bring together in their research unlikely pairs, such as privatization and democratic theory. The theory itself is thus reflexive, in the sense that it calls for integration in legal practice and correspondingly exemplifies hybridization in the academic field. Indeed, the theoretical basis for the Renew Deal vision mirrors its practical application in its inclusive spirit.[81]

With this spirit in mind, what follows is an attempt to develop—through an effort informed by the disciplines of psychology, sociology, and economics, together with game theory—a set of principles that help promote trustworthy behavior.

B. *What Makes People Trustworthy*

Research into human behavior in games and studies involving cooperation tends to reveal that economic

---

79. Some representative scholarship in this emerging field includes, for example, THE TOOLS OF GOVERNMENT: A GUIDE TO THE NEW GOVERNANCE (Lester M. Salamon ed., 2002); Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 345-56 (1998); Bradley C. Karkkainen, *"New Governance" in Legal Thought and in the World: Some Splitting as Antidote to Overzealous Lumping*, 89 MINN. L. REV. 471 (2004); James S. Liebman & Charles F. Sabel, *A Public Laboratory Dewey Barely Imagined: The Emerging Model of School Governance and Legal Reform*, 28 N.Y.U. REV. L. & SOC. CHANGE 183 (2003); and Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004). In Part IV, I will also suggest a method for approaching re-regulation of the financial system consistent with New Governance approaches.

80. Lobel, *supra* note 79, at 449.

81. *Id.*

behavior is in some ways predictable.[82] Whether such conduct is predictable rationally, as proponents of the Law and Economics school of thought would argue, or irrationally, like the behavioral economics posit,[83] is irrelevant for the sake of this discussion. Rather, we can inform policy-making moving forward by gathering information about how we respond to a range of forces: external conditions, like laws, monitoring, and oversight; promises to cooperate; and the features of our prospective partners in economic endeavors. Given the critical role that trustworthiness, as opposed to trust, must play in efforts to re-regulate financial markets, what follows in this section is a discussion of the results of a range of research into what conditions appear to make people trustworthy or untrustworthy. In sum, several critical themes arise from this literature review: that a lack of oversight and an absence of sanctions against cheating tend to increase the likelihood that people will cheat; that the more individuals participate in repeat cooperation games with the same

82. The most common of these games is the so-called prisoner's dilemma. The traditional setup of the prisoner's dilemma game is to imagine that there are two criminals who participated in the same crime and are being held by the police in separate interrogation rooms. The criminals are faced with a choice: each can choose to cooperate with the police, implicating his or her colleague while securing a lighter punishment for him or herself; or each can refuse to cooperate, leaving the police with little evidence with which to charge the detainees. If one cooperates and one does not, the one who refuses to cooperate will receive a stiff punishment. If both do not cooperate with the police, they will both be set free because the police need the testimony of the criminals to make their case. If both defect, and cooperate with the police, they will receive lighter punishments than if either of them refuse to give information to the police while the other sings like a canary. If the two criminals can coordinate their strategy, and agree to refuse to give the police any information, they both benefit from that strategy of cooperation (cooperation, that is, with each other, not the police). In the face of mistrust of the other criminal (and they *are* criminals after all), where there is a fear that the partner will defect and give the police the information they want, the wise strategy is to cooperate with the police as quickly as possible and rat out the other criminal in the hope of securing a lighter punishment. However the game plays out, collectively, the two should cooperate, while, individually, the wiser strategy is to defect, particularly if you fear the partner is a defection risk. Many cooperation games utilize this basic model, but with many different details and permutations. For a more in-depth description of this classic model, see, for example, ROBERT AXELROD, THE EVOLUTION OF COOPERATION 7-10 (1984).

83. *See* DAN ARIELY, PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS (2008).

partners, the more they are likely to engage in cooperative behavior; that greater social distance between the trustee and the trustor leads to greater rent seeking; and that communication by and between participants about norms of cooperation can increase the likelihood that individuals will engage in trustworthy behavior.

1. *Without Rules or Oversight, People Cheat.* Robert Ellickson has posited that there are three types of constraints on self-interested behavior: first-, second-, and third-party constraints.[84] First-party constraints are the limits one puts on one's own behavior because of motivations like a sense of personal honor.[85] Second-party constraints are the restraints on behavior imposed by others with whom we are engaged in cooperative behavior; these second parties can retaliate against us for our selfish actions, which encourages us to behave.[86] Third-party constraints are the punishments that third parties can exact on us for our disreputable conduct, like ostracism and shaming.[87] As Carol Rose points out, law, because of the potential punishment that backs it up, is a form of "formal" third party constraint.[88] Ellickson and others posit that, in many settings, informal, non-legal constraints are far more effective in policing behavior than formal ones.[89]

The classic Law and Economics approach to explaining law-breaking posits that individuals conduct rational, cost-benefit calculations of these constraints when determining whether to commit crimes or engage in anti-social behavior and that such a calculation includes an assessment of the

---

84. Robert C. Ellickson, *A Critique of Economic and Sociological Theories of Social Control*, 16 J. LEGAL STUD. 67, 71 (1987) (outlining typology of constraints).

85. *Id.* at 71.

86. *Id.* at 71-72.

87. *Id.*

88. Carol M. Rose, *Trust in the Mirror of Betrayal*, 75 B.U. L. REV. 531, 536 (1994).

89. Ellickson, *supra* note 84, at 81-90 (rejecting what he calls the "legal centralism" of modern law-and-economics scholars); *see also* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 60-67 (1963) (noting that business persons generally believe that formal contracts can be unnecessary in certain business dealings).

risk of being caught, the likely punishment for the act, and the benefits to be gained by such conduct.[90] To the extent that internal forces are at work that might discourage one from engaging in such behavior (e.g., one's concern with a personal sense of honor or one's fear of guilt), this can serve as a form of punishment in the cost-benefit analysis.[91] While unearthing the reasons people obey or do not obey the law is beyond the scope of this review,[92] an analysis of recent research into the role of oversight in reining in cheating is worthwhile. Such an analysis helps to inform the discussion of the forces that might lead to trust and trustworthiness. The results of this research show that without rules, people cheat. And most people cheat in such situations, at least a little bit.[93]

A collection of recent studies by behavioral economists Nina Mazar, On Amir, and Dan Ariely is particularly illuminating on this topic.[94] In those studies, conducted with graduate students as participants, the researchers set out to assess the conditions under which study participants might cheat.[95] In several different experiments, students were asked to answer a series of questions on a range of subjects.[96] The students were to be paid for the number of their correct answers on the tests,[97] were given a work sheet on which to submit their initial answers, as well as a final

---

90. *See* FRANKLIN E. ZIMRING & GORDON J. HAWKINS, DETERRENCE: THE LEGAL THREAT IN CRIME CONTROL (1973); Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

91. For a discussion of the role of norms, see Amitai Etzioni, *Social Norms: Internalization, Persuasion, and History*, 34 LAW & SOC'Y REV. 157 (2000); and Lawrence Lessig, *The New Chicago School*, 27 J. LEGAL STUD. 661 (1998).

92. *See, e.g.*, TOM R. TYLER, WHY PEOPLE OBEY THE LAW (1990) (identifying some of the external reasons people may obey the law, including the influence that their interactions with the legal system have on their perceptions of whether they consider it as fair).

93. *See* ARIELY, *supra* note 83, at 213.

94. *See id.*; *see also* Nina Mazar & Dan Ariely, *Dishonesty in Everyday Life and Its Policy Implications*, J. PUB. POL'Y & MARKETING, Spring 2006, at 1, 6 (citation omitted) (discussing a 2005 survey conducted by Nina Mazar, On Amir, and Dan Ariely).

95. ARIELY, *supra* note 83, at 198.

96. *Id.*

97. *Id.*

answer sheet, which they were to submit to the monitor for review.[98] In control situations, where monitors could also check the students' answers on their original work sheets and final answer sheets against the right answers on the quizzes, there was little opportunity for cheating.[99]

Several different scenarios were created where students would have the opportunity to cheat.[100] Some were given the right answers before they were to submit their final answer sheets; others were given the answers and had the opportunity to shred their initial answer sheets before they submitted their final tally sheets; and still others were given the answers, could shred their initial answers, and were allowed to withdraw the money they were to receive for the correct number of answers on their own.[101] In all "cheating friendly" scenarios, the average test scores rose when compared to the control group (although not by much overall and in each cheating scenario the average test scores were very similar).[102] Needless to say, the researchers did not think that the participants in the cheating scenarios were, on average, smarter than the control group.[103] Rather, they concluded that cheating explained the differences, and cheating, not by a few rogues cheating a lot, but, rather, by most participants cheating a little:

> What did we learn from this experiment? The first conclusion, is that when given the opportunity, many honest people will cheat. In fact, rather than finding that a few bad apples weighted the averages, we discovered that the majority of people cheated, and that they cheated just a little bit.[104]

In a world with weak oversight (i.e., where the risk of being caught is low) and few rules against cheating (as in financial sectors where deregulation is the norm, like in derivatives markets), the cost-benefit analysis would seem to encourage cheating, predatory conduct, and rent seeking.

---

98. *Id.*

99. *Id.*

100. *Id.* at 198-99.

101. *Id.*

102. *Id.* at 200.

103. *Id.*

104. *Id.* at 201.

Tragically, the subprime mortgage market, and the broader financial system, seem to have been areas ripe for cheating due to the general lack of oversight; an emphasis on deregulation by regulators and legislators; and an overheated mortgage market that encouraged overconfidence, speculation and excessive risk-taking. This dangerous mix brought about precisely what could have been anticipated: rent seeking, predation, blinding avarice, and unchecked greed. The guardians of the system have admitted that their philosophies with respect to market oversight were misguided and based on fundamental flaws. In testimony before Congress, Alan Greenspan, in a now infamous *mea culpa*, admitted the following: "I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were [sic] such is [sic] that they were best capable of protecting their own shareholders and their equity in the firms."[105] Christopher Cox, former Chairman of the SEC, when ending the Consolidated Supervised Entities program through which financial institutions that lacked a clear regulator could voluntarily submit to regulation, admitted that "voluntary regulation" of such entities "does not work."[106]

This discussion leads us to our first of the principles that helps to induce trustworthiness: rules and oversight matter. Without them, people are likely to behave in untrustworthy ways and seek to exploit the situation for personal gain.

2. *The Greater the Opportunities for Future Dealings with Partners in Repeat Play Games, the Greater the Likelihood that Participants will Exhibit Cooperative Behavior.* One of the fundamental findings of research into cooperative behavior is that participants are more likely to exhibit cooperative behavior if they expect to deal with the

105. *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 33 (2008) (testimony of Alan Greenspan, former Chairman, U.S. Federal Reserve Board), *available at*, http://oversight.house.gov/documents/20081024163819.pdf.

106. Press Release, Christopher Cox, Chairman, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), http://www.sec.gov/news/press/2008/2008-230.htm.

same playing partners on multiple occasions in the future.[107] Robert Axelrod has pointed out that the optimal strategy in repeat-play games is "tit-for-tat": where one participant models the behavior of the other participant with which he or she is partnered.[108] In such settings, cooperation is rewarded with cooperation and defection is punished with defection.[109] This "logic of reciprocity," as Dan Kahan calls it, reflects the fact that people will cooperate with others if cooperation is exhibited; they will defect when others defect.[110] The incentives in place—which encourage cooperative behavior towards newcomers in the hope of eliciting cooperative behavior, punishment for those who defect, and forgiveness towards those who attempt to restore cooperative behavior by exhibiting it themselves in the hope of eliciting it from their partners—tend to foster cooperative behavior among repeat players over the arc of repeat games.[111]

Furthermore, research suggests that the cooperative first move is likely to be the most beneficial move in repeat games, even if one risks exploitation by the game partner on

---

107. *See, e.g.*, Pedro Dal Bó, *Cooperation Under the Shadow of the Future: Experimental Evidence from Infinitely Repeated Games*, 95 AM. ECON. REV. 1591 (2005) (showing that cooperation increases as players interact repeatedly); Robert Evans & Jonathan P. Thomas, *Reputation and Experimentation in Repeated Games with Two Long-Run Players*, 65 ECONOMETRICA 1153-73 (1997) (showing that reputation comes into play when a game is repeated over the long-term leading to increased cooperation); Robert Gibbons, *Trust in Social Structures: Hobbes and Coase Meet Repeated Games*, *in* TRUST IN SOCIETY, *supra* note 41, at 332-49 (showing participants more likely to cooperate in repeat games because there is more likely a greater payoff from cooperation); *see also*, FOUNDATIONS OF HUMAN SOCIALITY: ECONOMIC EXPERIMENTS AND ETHNOGRAPHIC EVIDENCE FROM FIFTEEN SMALL-SCALE SOCIETIES (Joseph Henrich et al. eds. 2004) (collecting results from cross-cultural studies of cooperative behavior).

108. AXELROD, *supra* note 82, at 13.

109. *Id.* at 11-19 (discussing the emergence of cooperation in repeat-play prisoner's dilemma games); *see also* DAVID M. KREPS, GAME THEORY AND ECONOMIC MODELLING 65-89 (1990) (same).

110. Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71 (2003).

111. *See* AXELROD, *supra* note 82, at 109. For a hypothesis of why norms of cooperation develop in repeat play games, see ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 167-83 (1991).

his or her responsive move.[112] Since the tit-for-tat strategy is deployed most frequently, a cooperative first move is likely to generate a cooperative second move in response, generating the type of long-term benefits that can be derived from the trust game.[113]

As Robert Cooter points out, these repeat-play phenomena present themselves in commercial and business settings, encouraging cooperative behavior when repeat interactions are expected between business associates.[114] Repeat-play cooperation is also apparent in day-to-day commercial transactions; when a retailer wants to encourage future transactions with a potential customer, his or her present conduct will include offering competitive prices for the goods sold, better service, and reliable products, even if this conduct means a greater outlay of resources in the present to provide those services or lower profit margins on the goods sold.[115] Similarly, firms with a good reputation have a competitive advantage over firms that do not where future opportunities are based on past performance.[116] Research shows that even in a situation of great conflict—in one example, litigation—agents for the combatants, when those agents are themselves repeat players and deal with each other constantly, are able to foster cooperative behavior and bring their principals to agreements resolving the conflicts between them more often

---

112. *See* AXELROD, *supra* note 82, at 113-17 (suggesting that one should never be the first to defect); Diego Gambetta, *Can We Trust Trust?*, *in* TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS 227 (Diego Gambetta ed., 1988) (describing the benefits of a cooperative first move).

113. *See* AXELROD, *supra* note 82, at 31.

114. Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1657-77 (1996).

115. For a description of how cooperative behavior in repeat play games occurs in commercial settings, see, for example, Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, J. POL. ECON. 615 (1981); and Gilbert Roberts & James S. Renwick, *The Development of Cooperative Relationships: An Experiment*, 270 PROCEEDINGS: BIOLOGICAL SCI. 2279 (2003).

116. *See* David M. Kreps, *Corporate Culture and Economic Theory*, *in* PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 90 (James E. Alt & Kenneth A. Shepsle eds., 1990).

than agents who do not deal with each other with any frequency.[117]

3. *Greater Social Distance Increases Untrustworthy Behavior.* Research shows consistently that where there is greater social distance between individuals, they are both less trusting, and each is more willing to take advantage of the other person.[118] Like it or not, we trust those who are like us, whom we perceive as being members of the same group as ourselves.[119] We even tend to trust those who look more like us than those who do not.[120]

---

117. For research into the behavior of attorneys who frequently deal with each other and who exhibit a greater propensity to settle their cases than attorneys who do not, see Jason Scott Johnston & Joel Waldfogel, *Does Repeat Play Elicit Cooperation? Evidence from Federal Civil Litigation*, 31 J. LEGAL STUD. 39, 40-41 (2002). Similarly, when cross-border commerce was first evolving in the Middle Ages, merchants had to find ways to assess the trustworthiness of their trading partners in the absence of an ability to monitor defection from great distance or judge the quality of the goods traded. A class of intermediaries were created—the law merchant—that helped to spread information about the trustworthiness of trading partners. *See* Paul R. Milgrom et al., *The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges and the Champagne Fairs*, 2 ECON. & POL. 1, 3 (1990).

118. *See, e.g.*, Elizabeth Hoffman et al., *Social Distance and Other-Regarding Behavior in Dictator Games*, 86 AM. ECON. REV. 653, 658 (1996) (finding non-cooperative behavior increases with greater social distance). In Janet Landa's famous study of rubber traders in Singapore and Malaysia in the 1960s, she showed that a complex hierarchy of social relations determined the extent to which a trader trusted another trader, with those closest in kinship to the trader being trusted more, and with trust in the other trader decreasing as social distance increased. Janet T. Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 J. LEGAL STUD. 349 (1981).

119. *See* Uslaner, *Democracy and Social Capital*, *supra* note 28, at 123-24 (noting tendencies to trust friends and other members of a particular group as opposed to non-friends or non-members). This phenomenon reveals a paradox of trust and the benefits that can derived from generalized and broad reaching trust: "It might seem that we can only develop trust in people we know. Yet, trust's benefits come when we put faith in strangers." USLANER, *supra* note 27, at 1.

120. *See* Lisa M. DeBruine, *Facial Resemblance Enhances Trust*, 269 PROCEEDINGS: BIOLOGICAL SCI. 1307, 1311 (2002) (finding in the social dilemma game that a participant's willingness to trust others improved when images of a fictional partner in the game were manipulated to look more like the participant).

Social distance can be created by distinctions in race, gender, nationality, and language, among other differences.[121] From cross-country and cross-community analyses we learn that those nations and communities with more heterogeneous populations have lower generalized trust, and as that heterogeneity increases, trust decreases.[122] Another measure of social distance is income inequality, and societies with greater income inequality also have lower trust.[123] Indeed, generalized trust in the United States has declined in recent years as income inequality has increased.[124]

The effects of social distance can be found in discriminatory lending practices and real estate transactions. Lowered trust and heightened suspicion lead to more predatory conduct and less cooperative behavior. The fictional salesmen of John Steinbeck's *The Grapes of Wrath* took advantage of the poor farmers looking to purchase cars for the long journey to the West, treating them as gullible, desperate, simple and uninformed: also, of a lower class.[125] Mortgage brokers in the subprime mortgage market exploited asymmetries of information to market and sell mortgage products to prospective borrowers from communities where credible lending options were scarce. While at least some of these lenders allegedly exploited borrowers' trust because they *shared* similar racial

121. For an overview of the concept of social distance, see Elizabeth Hoffman et al., *supra* note 118.

122. *See, e.g.*, Iris Bohnet & Bruno S. Frey, *The Sound of Silence in Prisoner's Dilemma and Dictator Games*, 38 J. ECON. BEHAV. & ORG. 43, 46 (1999) (finding greater likelihood of giving where there is greater closeness between individuals); Alberto Alesina & Eliana La Ferrara, *The Determinants of Trust* (Nat'l Bureau of Econ. Research, Working Paper No. 7621, 2000) (noting, inter alia, that increases in heterogeneity within communities decreases levels of trust within communities).

123. *See* Paul J. Zak & Stephen Knack, *Trust and Growth*, 111 ECON. J. 295, 312-13 (analyzing various measures of income inequality within various countries and finding that such inequality "is significantly related to" a decline in trust in those countries).

124. USLANER, *supra* note 27, at 165-81.

125. JOHN STEINBECK, THE GRAPES OF WRATH 61-66 (Penguin Books 2002) (1939).

characteristics,[126] the economic chasm between well-compensated Wall Street executives and the working poor borrowers who had subprime loans foisted on them was wide and deep. It is likely, then, that the social distance between creditor and debtor likely exacerbated the abusive lending practices that were so rampant during the earlier part of this decade.

4. *Communication and Expressions Directed Towards Encouraging Cooperative Behavior Lead to Greater Trustworthiness.* In one of the earliest prisoner's dilemma experiments, subjects who were allowed to exchange notes promising cooperation in advance of a trust exercise tended to cooperate at a higher rate than those participants who did not exchange similar promises.[127] Furthermore, in a range of prisoner's dilemma games, generally speaking, when participants were directed by an outside agent in a position of apparent authority (i.e., the monitor of the experiment) to cooperate or compete, the participants followed instructions at a greater rate than if no direction was given either way.[128] In fact, the direction to cooperate was followed with greater frequency than the direction to compete.[129] Communication itself, even without an exchange of promises to cooperate, can increase empathy between parties and decrease social distance, leading to greater trust regardless of such distance.[130]

---

126. For example, in one case, Barkley v. Olympia Mortgage Co., No. 04-CV-875, 2007 U.S. Dist. LEXIS 61940, at *36-37 (E.D.N.Y. Aug. 22, 2007), plaintiffs alleged that the defendants engaged in targeting of borrowers for unfair loan terms along racial lines by, inter alia, advertising in newspapers patronized primarily by the communities of color in Brooklyn, New York and matching borrowers of color with salespeople of color.

127. *See* James L. Loomis, *Communication, the Development of Trust, and Cooperative Behavior*, 12 HUM. REL. 305, 314-15 (1959).

128. *See* David Sally, *Conversation and Cooperation in Social Dilemmas: A Meta-Analysis of Experiments from 1958 to 1992*, 7 RATIONALITY & SOC'Y 58, 86-87 (1995) (analyzing results of prisoner's dilemma games); *see also*, Elinor Ostrom et al., *Covenants With and Without a Sword: Self-Governance is Possible*, 86 AM. POL. SCI. REV. 404 (1992) (describing effects of communication on cooperation in prisoner dilemma games).

129. *Id.*

130. Donna M. Desforges et al., *Effects of Structured Cooperative Contact on Changing Negative Attitudes Toward Stigmatized Social Groups*, 60 J.

Another interesting study from Dan Ariely and his colleagues reveals the impact of even unilateral communications regarding trustworthiness.[131] In a series of experiments, similar to the ones described above, students were asked to solve a range of math equations.[132] A control group was asked to solve the questions without any assistance.[133] Another group was asked to solve the problems, then write down on another sheet of paper the number they solved correctly.[134] These participants were then allowed to discard their work sheets so that the monitor could not check whether the number of correct answers they recorded was accurate.[135] As one can probably guess by now, this group was the one more likely to cheat.[136] The researchers added a twist, however; prior to taking the test, the students in both groups were asked to engage in a thought exercise.[137] A sub-group of each group was asked to write down ten books they had read in high school while a second sub-group was asked to write down as many of the Ten Commandments as they could remember.[138] The results of this study were striking. The students asked to list ten books and who discarded their answer sheets reported to have scored an average of thirty-three percent better than those in the original control group.[139] Those students who

---

PERSONALITY & SOC. PSYCHOL. 531 (1991); *see also* John M. Orbell et al., *Explaining Discussion-Induced Cooperation*, 54 J. PERSONALITY & SOC. PSYCHOL. 811, 811 (1988) (finding communication "greatly increases the incidence of cooperation" between group participants in cooperation games); Sally, *supra* note 128, at 78 (analyzing results of prisoner's dilemma games and finding cooperation increased by forty percent when participants engaged in conversation before the experiment). On the importance of freedom of speech protections to promote greater communication between citizens in a democracy, see Jason Mazzone, *Speech and Reciprocity: A Theory of the First Amendment*, 34 CONN. L. REV. 405, 436-37 (2002).

131. Nina Mazar, On Amir & Dan Ariely, *The Dishonesty of Honest People: A Theory of Self-Concept Maintenance*, 45 J. MARKETING RES. 633 (2008).

132. *Id.* at 635-37.

133. *Id.* at 635-36.

134. *Id.*

135. *Id.* at 636.

136. *Id.*

137. *Id.* at 635.

138. *Id.* at 635.

139. *Id.* at 636.

were asked to recite the Ten Commandments and who discarded their answer sheets scored the same as the control group, and the number of the Commandments they could recall bore no relation to their final score.[140] In a similar study by Ariely and his colleagues, students were given an additional opportunity to cheat when they were asked to discard their answer cards. A sub-group of these students was also asked to sign a pledge prior to submitting their answers that they understood the test was being administered under the school's honor code (even though the school in question, M.I.T., had no honor code at the time).[141] Those students who did not sign the honor pledge claimed to have solved almost twice as many problems correctly as the control group in that study; those who signed the honor pledge scored the same as the control group.[142]

The results of these and the studies referenced above lend support to the proposition that certain types of communication can foster cooperative and pro-social behavior: promises to cooperate between parties; instructions to cooperate by monitors; and unilateral communications regarding pro-social behavior. The implications for the role that law can play in fostering cooperative behavior are obvious: communications between parties should be facilitated wherever possible, the role monitors play in fostering cooperation should be clear and should encourage cooperation, and parties should be asked to make pledges that they will behave in pro-social ways.

In the financial services context, a series of steps could incorporate the lessons from these findings: fostering communications between actors within the system (by enhancing face-to-face disclosure requirements), ensuring financial firms understand the role regulators play in overseeing the conduct of such firms, and expanding the creation of fiduciary relationships (where agents would profess their duties to their principals). I will return to these and the other principles set forth above in subsequent discussions.[143]

---

140. *Id.*

141. *Id.* at 636-37.

142. *Id.* at 637.

143. *See infra* Part IV.

III. LAW AND TRUST

Can efforts to bring new regulatory oversight to the financial system generate the trust that everyone agrees is necessary to rejuvenate the economy? Some argue that law diminishes trust because it reduces the need for interpersonal trust to mediate and promote human cooperation.[144] Others believe that informal norms and social controls are more efficient and effective in ensuring trustworthy behavior than regulatory regimes; indeed, such norms can often operate effectively despite the existence of an overarching regulatory regime.[145] Such arguments might hold true in tight-knit, homogenous communities, where a range of sanctions—from informal shunning and reputational harm to physical violence through self-help—might prove effective in maintaining "order without law" as Robert Ellickson suggests.[146] In the fictional Mayberry, a small community where everyone knows everyone else's business and commerce occurs on a regular basis within the community, and where the fear that one might lose face, or business partners, for disreputable conduct or unfair dealings is real, such arguments are more likely to hold true.[147]

---

144. Numerous critics have assailed efforts to substitute law for trust. *See, e.g.*, FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY 27 (1995) (arguing that where law has become a substitute for trust, it has brought about the breakdown of trusting relationships); *id.* at 309-11 (arguing that trust has been displaced by legalistic approaches to societal disputes that are less effective and efficient); MARY ANN GLENDON, RIGHTS TALK: THE IMPOVERISHMENT OF POLITICAL DISCOURSE (1991) (arguing that adherence to the protection of individual rights through law undermines creation of a community of shared interests); Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 580-84 (2001) (arguing that regulation promotes opportunistic behavior that undermines trust).

145. *See, e.g.*, ELLICKSON, *supra* note 111.

146. *Id.*

147. Even Ellickson remains "agnostic" about whether heterogeneous groups can develop the types of informal controls that tight-knit groups might generally develop:

> The hypothesis predicts that welfare-maximizing norms emerge in close-knit settings but is agnostic about whether such norms can emerge in other social settings. This qualification is necessary because an informal-control system may not be effective if the social conditions within a group do not provide members with information about norms

In a flat world,[148] where billions of dollars flow across national borders at the stroke of a computer key, and thousands of faceless transactions occur by the second throughout the globe, it is difficult to imagine informal norms and sanctions taking root and producing the types of efficient outcomes that such norms may generate in other settings. Indeed, the weak regulatory oversight of the shadow banking system both fed and gorged on the securitization of millions of mortgages without the bankers that arranged those deals, or the investors who purchased the fruit of those deals, ever meeting a single borrower. Given what we know about cooperation, predation, oversight, and social distance, it is hardly surprising that the subprime mortgage frenzy, with its layers of complexity constructed in an ever weakening regulatory environment, triggered a broad and deep financial crisis, noteworthy in many respects for a calamitous combination of blind faith and bad acts.

Can an effort at re-regulation promote the type of trustworthy behavior we need to foster trust in the financial system? To paraphrase Edmund Burke: to make us trust in the financial system, it must be trustworthy.[149] There is a growing body of scholarship that shows that law can promote trust, particularly in larger, heterogeneous communities where trust alone may not operate effectively to promote cooperation and curb predatory behavior. Since law can promote trust, and since we have come to learn that trust is both a reflection of our expectations that others will act in a trustworthy fashion as well as our internal assessment of the extent to which we, ourselves, are trustworthy, there is an obvious symbiotic relationship between trusting and trustworthiness. The discussion that follows draws from the growing scholarship on the influence

---

> and violations and also the power and enforcement opportunities needed to establish norms.

Id. at 177 (footnote omitted).

148. *See generally* THOMAS L. FRIEDMAN, THE WORLD IS FLAT: A BRIEF HISTORY OF THE TWENTY-FIRST CENTURY (2005).

149. When commenting on the revolution in France, Edmund Burke wrote: "To make us love our country, our country ought to be lovely." EDMUND BURKE, REFLECTIONS ON THE REVOLUTION IN FRANCE, AND ON THE PROCEEDINGS IN CERTAIN SOCIETIES IN LONDON RELATIVE TO THAT EVENT IN A LETTER INTENDED TO HAVE BEEN SENT TO A GENTLEMAN IN PARIS 116 (1790).

of law and trust, and generates some potential conclusions about the role of law in promoting trustworthiness.

Law can promote trust in several ways. The presence of laws to enforce contracts and protect property rights expands the metaphorical "circle of trust" and allows economic ventures to occur between actors and firms that do not have close, personal relationships founded strictly on affective trust.[150] Similarly, the presence of laws and an oversight regime can reduce the need for information about the reliability of those in whom one places trust. In such situations, one can rest instead on the confidence in the system's laws and oversight mechanisms to reduce the likelihood of rent seeking, or improve the likelihood that such rent seeking will be punished. The presence of such a legal regime thus encourages others to engage in cooperative behavior.[151]

When people are confident in the legal regime to punish cheating, people are more trusting.[152] Similarly, the availability of contract remedies—those sanctions associated with enforcement of contract obligations against contract breakers—encourages parties to contract in the first place and strengthens trust by increasing the belief in the trustworthiness of others (due to knowledge that others are unlikely to break their contracts if sanctions are available).[153] Confidence in those sanctions to foster

150. *See, e.g.*, Cross, *supra* note 16, at 1499 ("While law may *reduce* the need to rely on trust, this effect may end up extending the range of possible transactions rather than undermining those that can rest entirely on trust."); Simon Deakin et al., *Contract Law, Trust Relations, and Incentives for Co-operation: A Comparative Study*, *in* CONTRACTS, CO-OPERATION, AND COMPETITION: STUDIES IN ECONOMICS, MANAGEMENT, AND LAW 105, 133 (Simon Deakin & Jonathan Michie eds., 1998) ("Institutional forces [like contract law] do not simply constrain individual agency, but channel contractual behavior which would not otherwise be feasible.").

151. *See, e.g.*, NIKLAS LUHMANN, TRUST AND POWER 50-51 (1979). Whether this type of calculative decisionmaking—that I will have confidence in the law to serve as a hedge against untrustworthy behavior, and so I "trust" another enough to engage in business relations with him or her—can be considered "trust" is irrelevant. What matters is the cooperative conduct that is a product of that confidence.

152. Alesina & La Ferrara, *supra* note 122, at 3 (discussing how effective criminal prosecution leads to more trusting behavior).

153. *See* Simon Deakin et al., *supra* note 150, at 105-43 (discussing how contracts have a significant and positive effect on trust); Mark Granovetter,

trustworthy behavior minimizes the need to monitor the conduct of the trusted, particularly where such monitoring, itself, can reduce feelings of trust[154] (although this is not always the case–the presence of monitoring can also generate feelings of trustworthiness, as the discussion of the study by Coletti and others, discussed below, shows). Contract law and its remedies can encourage both trusting and trustworthy conduct: "By giving legal assurances of remedies for breaches of trust, the law makes parties more likely to be both trusting (thanks to the hedging effect of the legal remedy) and trustworthy (to avoid sanctions)."[155]

While common wisdom might suggest that controls on behavior can be costly and can lead to reduced trust because the subjects of that control fear other participants are less trustworthy (hence the need for controls),[156] at least one series of studies has shown that controls on behavior can actually lead to greater perceptions of the trustworthiness of the subjects of those controls, as well as more cooperative behavior.[157] Participants in this study of cooperative behavior were asked to assess the trustworthiness of other participants in an experiment where participants played the role of managers of companies and given control over research budgets.[158] They were then asked to commit

Economic Action and Social Structure: The Problem of Embeddedness, 91 AM. J. SOC. 481, 491 (1985) (describing how institutional arrangements like contracts generate trust).

154. *See, e.g.*, Cross, *supra* note 16, at 1501 (arguing that when monitoring is necessary in the absence of contract remedies, such monitoring can cause distrust).

155. Cross, *supra* note 16, at 1483. Law can also have an "expressive function" such that laws that promote cooperation and encourage trustworthy behavior can, themselves, generate trust. *See, e.g.*, Jason Mazzone, *When Courts Speak: Social Capital and Law's Expressive Function*, 49 SYRACUSE L. REV. 1039, 1041 (1999) (discussing the expressive function of law, and its impact on norms); Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338 (1997); Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996). Law can also "frame" a norm of cooperation by creating a cooperative social context in which trusting and trustworthy behavior are encouraged. *See* Blair & Stout, *supra* note 16, at 1796.

156. *See, e.g.*, Ann E. Tenbrunsel & David M. Messick, *Sanctioning Systems, Decision Frames, and Cooperation*, 44 ADMIN. SCI. Q. 684 (1999).

157. Coletti et al., *supra* note 16, at 477.

158. *Id.* at 486-87.

resources to cooperative ventures with managers from other fictional companies.[159] There were benefits to cooperating with the other companies/participants but also rewards for non-cooperative behavior.[160] Some of the participants were monitored to determine if they engaged in cooperative behavior and some were not and all were told whether they were monitored or not.[161] A third observer/participant was then asked to assess the trustworthiness of the participants in charge of the research budgets to determine whether their actions were cooperative or not.[162] Regardless of the actual conduct of those observed participants, the observers regularly perceived the participants under the monitoring and control system as more trustworthy than the participants under no controls or monitoring, merely because of their faith in the monitoring system to encourage trustworthy behavior.[163]

A second experiment then also tested the lasting effect of cooperative conduct on repeat players, even after the monitoring controls were removed.[164] The results of the second test showed cooperative behavior continued even after participants that were the subject of controls were informed that the controls had been lifted.[165] Those participants cooperated more frequently in subsequent trials than those who had never been subject to monitoring, even after the parties learned the monitoring had ended.[166]

The authors of this study conclude as follows:

> This study suggests that one approach to increasing trust is to strengthen the control systems used to govern collaborative agreements, both in terms of their incentives and their feedback. That is, through increased monitoring, sanctioning, and rewarding, firms can induce higher levels of cooperation. The control-induced cooperation, when observed by collaborators via feedback mechanisms such as performance reports, will engender

159. *Id.* at 486.

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.* at 489.

164. *Id.* at 490-93.

165. *Id.* at 493-96.

166. *Id.* at 495.

trust, thereby reinforcing the positive effects of the control mechanisms.[167]

The feedback effect that occurred as a result of the monitoring and oversight reveals another impact that law can have on trust: law can promote trusting and trustworthy behavior, which, in turn, increases trust and encourages more cooperation in the future. In other words, law can help encourage the initial cooperative move that is so important for encouraging trusting and cooperative behavior. Once parties begin to engage in cooperative behavior, and such behavior is productive and beneficial, this conduct can serve to establish a base of trust from which more cooperative behavior can be launched. Thus, the legal infrastructure can encourage both trusting and trustworthy behavior, and lead to more of both in the future. "Because legal structures penalize those who would breach trust, they encourage and reward trustworthy behavior. Hence, as the amount of trustworthy behavior in society consequently increases, a raising of the affective trust baseline should generally follow."[168] In this way, instead of crowding out trust, trust and a legal regime can be complementary.[169]

Just as the level of trust present in a society generally has a positive impact on growth, nations that have strong investor protections, and which honor the rule of law and contract and property rights, tend to have higher rates of economic growth than low trust/weak rule of law nations.[170]

167. *Id.* at 478-79.

168. Cross, *supra* note 16, at 1509.

169. ROSALINDE KLEIN WOOLTHUIS ET AL., ERASMUS RESEARCH INSTITUTE OF MANAGEMENT, TRUST AND FORMAL CONTROL IN INTERORGANIZATIONAL RELATIONSHIPS 12 (2002).

170. *See, e.g.*, Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 834-37 (2001) (finding that stronger investor protections promoted higher levels of investment); Cross, *supra* note 16, at 1516-17 (discussing the value of strong investor protections in investing); *see also* Daron Acemoglu & Simon Johnson, *Unbundling Institutions*, 113 J. POL. ECON. 949, 988 (2005) (finding robust evidence that property rights institutions "have a major influence on long-run economic growth"); Cross, *supra* note 16, at 1525-27 (analyzing several measures of the rule of law within nations and finding strong correlation between the rule of law and economic growth); Martin Leschke, *Constitutional Choice and Prosperity: A Factor Analysis*, 11 CONST. POL. ECON. 265 (2000) (analyzing cross-country data and

This makes intuitive sense. Investors are more willing to invest in stock markets or to place funds on deposit with banks, if they feel that there are strong investor protections within those markets and healthy regulatory oversight of those financial institutions. And more risk-taking and investment leads to greater economic activity. Potential economic partners are more willing to cooperate and enter into mutually beneficial partnerships when they feel they can pursue contract remedies if the obligations imposed by their agreements are violated. Potential property owners are more likely to purchase property if they are confident that their interests will be protected by the property rights regime and their property will not be expropriated by the state arbitrarily.

This last point seems to lead to yet another fairly obvious conclusion about trust, law, and trustworthiness: rule of law, investor protections, property rights, and contract laws not only foster trust, but they lead to trustworthiness. These protections signal to potential cheaters that violations of trust will be prosecuted and abuses of trust punished. Whether such behavior is a product of benevolence or calculated concern about sanctions is irrelevant. Furthermore, the connection between rule of law and economic activity is not coincidental: less rent seeking and predatory conduct will lead to more consistent economic growth, greater cooperation in the future and better, more sustainable

---

showing rule of law promoted economic growth); Ismail Serageldin & Christiaan Grootaert, *Defining Social Capital: An Integrating View*, *in* SOCIAL CAPITAL: A MULTIFACETED PERSPECTIVE 40, 50 (Partha Dasgupta & Ismail Serageldin eds., 1999) (comparing effectiveness of informal norms in Brazilian garment industry and formal mechanisms in Chilean garment industry and showing higher economic activity in Chile). Proponents of New Institutional Economics promote the effectiveness of formal laws and informal norms in fostering economic growth, particularly in the developing world. *See, e.g.*, KENNETH W. DAM, THE LAW-GROWTH NEXUS: THE RULE OF LAW AND ECONOMIC DEVELOPMENT 16-17 (2006) (arguing that the existence of formal laws, promotion of the rule of law, and informal norms are critical to economic growth in the developing world); HERNANDO DE SOTO, THE OTHER PATH: THE INVISIBLE REVOLUTION IN THE THIRD WORLD (1989). For a critique of the effectiveness of transporting rule of law concepts into developing economies, see for example, Katharina Pistor, *The Standardization of Law and Its Effect on Developing Economies*, 50 AM. J. COMP. L. 97, 124-29 (2002); and David M. Trubek & Marc Galanter, *Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development Studies in the United States*, 1974 WIS. L. REV. 1062, 1089-93.

economic activity moving forward. The interplay between norms of trust, institutional protections against untrustworthy behavior and long-term economic activity has been described as follows:

> Interpersonal trust and cultural norms are essential elements in long-term trading relationships, but whether either of these can flourish for long in the absence of support from more permanent institutional forms may be doubted. Systems built up around rigid forms of normative regulation may seem to carry a short-term cost in terms of their inflexibility and lack of responsiveness to external change by comparison to systems which are more open to entry and where the impact of competitive forces is more immediate. But equally, this very rigidity and permanence of institutions may be a source of competitive advantage: in the longer run it may be that strong and stable institutional mechanisms are needed to promote dynamic efficiency, in terms of the capacity of a productive system to promote innovation and adaptation.[171]

While this is an observation about trust in general, if trustworthiness can be complemented by the legal infrastructure, it will produce trust moving forward: "*[T]rustworthiness commonly begets trust.* My trustworthiness potentially rewards your trusting me (if you act on your trust). Hence, if something conceptually entails or causes trustworthiness, then indirectly it tends to cause trust."[172]

Perhaps close-knit communities that are high in social capital operate efficiently and effectively, where sanctions for anti-social behavior are powerful, although informal. The global financial infrastructure is well beyond the reach of such informal sanctions, and legal institutions are necessary to rein in predatory conduct.

> [A]s the modern capitalist State matures, representative forms of governance with a clear hierarchical structure and a system of laws, rules, and regulations enforced by traditions replace the "community" as the guardian of social, business and personal contracts—and as the sole agent with a preemptory right to use force. The point is simple: one form of "social capital" is partly replaced by what might be thought of as another, an effective

171. Simon Deakin et al., *supra* note 150, at 134.

172. Russell Hardin, *Conceptions and Explanations of Trust*, *in* TRUST IN SOCIETY, *supra* note 41, at 17.

> Webbehan bureaucracy that either substitutes or complements it in accomplishing the same sort of things—nonmarket allocation and distribution.[173]

Law thus plays a complementary role in fostering, extending, and rewarding trust. It broadens one's range of potential trading partners. It serves to both identify and communicate the range of acceptable conduct, and punish what is beyond that range. It protects property interests and contract rights, which facilitates trust, economic activity and productive uses of property. Because of the beneficial effect of law on trust, attempts to foster trust and trustworthiness in the economy, through re-regulation of the financial system, are worthy of our attention and effort. What follows is an application of some of the principles set forth above in the context of the need for re-regulation of the financial system, including an analysis of how trust and law broke down in the lead up to the financial crisis, and where they seem to have served to prevent predatory and reckless conduct effectively.

IV. RESTORING TRUST TO THE FINANCIAL SYSTEM: PRINCIPLES TO INFORM RE-REGULATION THAT WILL HELP RESTORE TRUST

In this part, I will review the application of the four principles set forth above—oversight, repeat play, social distance and communication—and assess the ways in which they might have been present or absent in the events that led to the financial crisis. I will make some modest and general proposals for how these principles might be invoked in the process of re-regulation: to match the ends of re-regulation with effective means.

A. *Oversight and Enforcement*

First and foremost, to restore an ethic of trustworthiness in the financial system, there are a number of legal black holes that must be eliminated, where either a lack of regulation or positive legal exemptions exist that shield certain actions or products from serious legal or regulatory oversight. In these sections, I will address just three: credit rating agency practices that are purportedly

173. Joseph E. Stiglitz, *Formal and Informal Institutions*, *in* SOCIAL CAPITAL: A MULTIFACETED PERSPECTIVE, *supra* note 170, at 65.

shielded by free speech protections; assignees of securitized loans that are shielded by the holder in due course doctrine from liability for illegality in the consummation of the loans in their portfolios; and the exemption of such products as credit default swaps from regulation.

1. *Credit Rating Agency Protections.* Credit Rating Agencies are private entities that assess the creditworthiness of financial products. While there are certain instances where their role in assessing the creditworthiness of a particular financial product is mandated by federal statute, they are often recruited by the issuers of a financial product in the hope that the agency's assessment of that product will give confidence to potential investors in the value of and risk associated with it. Such investors will, in effect, delegate the role of investigating the product to the agency, often leaving the due diligence in assessing the risk associated with investing in that product to those agencies. The credit rating agencies have a preeminent importance in the financial system,[174] mostly as generators of investor trust, which, in turn, greases the wheels of investment by giving investors confidence as they make decisions about investing.[175] Another striking reality about the credit rating agencies is that they are largely immune from both regulation and private legal liability. Credit rating agencies are licensed by the SEC,[176] but there is little oversight of these entities once they receive SEC approval to operate. Indeed, in a legislative sleight of hand that accomplished deregulatory ends through the guise of affirmative legislation, while Congress authorized the SEC to license the rating agencies, it also prohibited that body

174. In 1996, Thomas Friedman of the *New York Times* famously said: "There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful." *Public Broadcasting System, Newshour* (PBS radio broadcast Feb. 13, 1996), *available at* http://www.pbs.org/newshour/gergen/friedman.html.

175. Such ratings became a "heuristic," a shorthand or proxy for the relative quality of the assets backing certain securities that assisted potential investors in making investment decisions with respect to those securities. On the functioning of heuristics, see *infra* Part IV.

176. *See* 15 U.S.C. § 78o-7 (2006).

from regulating "the substance of credit ratings or the procedures and methodologies" employed by the rating agencies.[177] Apart from this regulatory vacuum, in most instances, the ratings agencies are immune from private liability for the forecasts they issue; their ratings are treated as commercial speech, protected by the First Amendment to the U.S. Constitution, and thus insulated from most legal challenges from investors arguing that they relied on rating agency statements about a particular investment.[178]

In addition to the lack of oversight over credit rating agencies in the buildup to the subprime mortgage crisis, these agencies faced a clear conflict of interest; they were paid by the issuers of subprime securities to assess the creditworthiness of the borrowers whose mortgages backed those securities.[179] If an issuer did not like the credit rating it received from a credit rating agency for a particular round of securities it was issuing, not only could that issuer shop around for other rating agencies to review those securities, it could take future ratings business elsewhere.[180] As a

---

177. § 78o-7(c)(2).

178. *See, e.g.*, Deryn Darcy, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 COLUM. BUS. L. REV. 605, 632-33 ("[C]ourts have proven somewhat receptive to the agencies' arguments that their ratings are opinions protected under the First Amendment.") (footnote omitted); Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1055 (2009) ("This First Amendment hurdle has made it extraordinarily difficult to establish that rating agencies engaged in libel and has left issuers without legal recourse except in outlier cases.").

179. *See* Darcy, *supra* note 178, at 622-27 (describing the "issuer pays" conflict of interest).

180. *See, e.g.*, Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 246-48 (2009) (describing the conflict of interest in the "issuer pays" business model); Manns, *supra* note 178, at 1052-53 (describing the inherent conflict of interest in relationships between rating agencies and issuers); Roy C. Smith & Ingo Walter, *Rating Agencies: Is There an Agency Issue?*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 289, 302-04 (Richard M. Levich ed., 2002) (describing competition among ratings agencies that can lead to the issuance of more favorable ratings to attract and maintain issuer-customers). For an argument for creating a user-pays compensation system), see Manns, *supra* note 178, at 1059-69. For an argument that the prospective reputational harm to rating agencies that results from poor performance is

result, there were clear economic incentives that drove rating agencies to issue ratings that met with the approval of the issuers: they feared the present and future loss of business if they did not.

When mixed with the lack of regulatory oversight and the "virtual immunity" from liability from private parties,[181] such incentives were ultimately disastrous and led to poorly supervised ratings practices that failed to take into account adequately the risk associated with mortgage-backed securities and their core and systemic vulnerability to a broad downturn in the housing market. Of course, it was this historic downturn in the market that precipitated the present financial crisis. And the credit rating agencies either failed to take the possibility of such a downturn into account when issuing their ratings, or because of the incentive structure, neglected to warn the issuers of mortgage-backed securities that such a downturn could threaten the viability of those securities. In either scenario, they failed to provide the type of sober forecasts and assessments of the securities they were rating, which gave investors a false sense of confidence when purchasing securities blessed by those agencies.

The Obama Administration's regulatory plan suggests a list of principles to inform the imposition of more stringent regulation on ratings agencies.[182] Greater regulatory oversight is obviously necessary, and private liability must be imposed, particularly in situations where conflicts of interest might cloud the judgment of the ratings agencies. A proposal that would restore trust in the credit ratings agencies would encourage them to assume, on a voluntary basis, a fiduciary relationship with the investors that rely on their ratings. Through the assumption of such a

---

sufficient to rein in rating agency conduct see Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1.

181. *See* JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 302 (2006) (noting credit rating agencies' "virtual immunity" from liability in private litigation).

182. The Obama Plan stresses the need for greater transparency through the disclosure of the ratings agencies' methodologies, the potential conflicts of interest under which the agencies operate and the risks associated with the products the agencies assess. *Obama Plan*, *supra* note 3, at 46-47. It also calls for the reduction of the use by regulators of credit ratings agencies "in regulations and supervisory practices, wherever possible." *Id.* at 46.

relationship, they would have to proceed in a manner that was free of conflicts of interests, could not engage in self-dealing, and would be compelled to put the interests of the client-investor ahead of their own.[183] Adopting such a relationship voluntarily would send a clear signal to potential investors that the rating agencies agreed, at a minimum, to be conflict-free in their assessments of the investments they rate.[184] It would thus "frame" the relationship as one bounded by trust, where the rating agency agreed to be held accountable for breaches of that trust.[185] Indeed, the failure to honor such fiduciary obligations would subject the agencies to legal liability to their clients—who would be, again, the potential investors, *not* the issuers.

Rating agencies could choose to assume this duty and would be required to disclose whether they were willing to assume a fiduciary relationship or not, preferably in a large-type disclosure that could be transmitted with any rating the agency generated. In order to promote the most confidence in rating agencies that assumed the duty, and to discourage rating agencies from choosing not to assume the duty, any disclosure would have to be particularly explicit. For example, the rating agency that chooses not to adopt the fiduciary relationship should have to reproduce a disclosure like the following, in large type:

> The credit rating agency issuing the rating of this security has not agreed to enter into a fiduciary relationship with the investor who may or may not rely on this rating. This means that this rating may be influenced by a conflict of interest, and the agency has not agreed to be liable to the investor in the event there are errors in

183. For an overview of fiduciary obligations, see generally Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 BUFF. L. REV. 99 (2008); Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 71-79 (John W. Pratt & Richard J. Zeckhauser eds., 1985); and Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983).

184. I have proposed this same sort of voluntary assumption of fiduciary duties in the context of the borrower-mortgage broker relationship. *See* Raymond H. Brescia, *Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response*, 56 CLEV. ST. L. REV. 271, 304-05 (2008).

185. *See, e.g.*, Blair & Stout, *supra* note 16, at 1796 (arguing fiduciary law "frames" relationships to encourage trustworthy behavior).

> this rating and may put the interests of the rating agency or the issuer of the security ahead of the interests of the investor.

Hopefully, investors reading such a disclosure would be discouraged from relying on the report of the rating agency. It is likely that rating agencies will be forced to adopt such duties or risk being driven out of the market by those agencies willing to do so.

2. *Assignee Protections.* Another mechanism that reduces accountability in the financial industry, particularly in the operation of the mortgage securitization process, is the so-called "holder in due course doctrine."[186] This doctrine was adopted to shield innocent purchasers of interests from any alleged fraud or other illegality in the initial creation of that interest and works to ensure that such purchasers can have faith in their purchases (another instance of an aspect of the legal architecture that builds trust and leads to greater economic activity).[187] This doctrine can, in effect, "scrub" otherwise defective instruments of the tarnish of illegality that may have been present in the creation of the interest, including fraud and unconscionability.[188] The doctrine is particularly relevant in the subprime mortgage market because of the common practice of bundling

---

186. *See, e.g.*, Vern Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit,* 52 TEX. L. REV. 1, 2 (1974) (describing the holder in due course doctrine).

187. Engel and McCoy have described the doctrine as follows:

> To satisfy the requirements of a holder in due course, the purchaser must be the holder of a negotiable note, who took the note for value, in good faith, and without notice that the note contains certain defects. To meet the definition of a "holder," the assignee must possess the note and the note must be "issued or indorsed to him or to his order or to bearer or in blank." If a note is payable to an identified person or entity, the note must bear an endorsement or be among a group of loans to which an allonge was attached. When assignees qualify as holders in due course, they take the notes free of most defenses to nonpayment and affirmative claims that borrowers could have pursued against the originators.

Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending,* 75 FORDHAM L. REV. 2039, 2053 (2007); *see also* Countryman, *supra* note 186, at 2 (describing the holder in due course doctrine).

188. JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §§ 14-1, 14-2 (5th ed. 2000).

subprime mortgages into pools of loans and issuing securities backed by those loans. The holders of the securities are likely to invoke the protection of the holder in due course defense to shield them from liability in the consummation of the loans that serve as the collateral for and income streams of the mortgage-backed securities.[189] The invocation of such a defense, if successful, would shield the purchasers of subprime securities from claims of borrowers that the underlying mortgages were the products of discriminatory or other illegal acts. Yet there are many exceptions to this defense,[190] including that the assignee knew or had reason to know that there was some irregularity in the mortgage or other interest he or she purchased.[191] Moreover, several statutes such as the Truth in Lending Act (TILA)[192] and Home Ownership Equity Protection Act (HOEPA)[193] have exemptions from the doctrine;[194] the Fair Housing Act (FHA) and the Equal Credit Opportunity Act (ECOA) extend liability for discrimination in certain circumstances,[195] and many have argued that this doctrine should be inapplicable in the context of subprime lending.[196] A bill currently pending

189. *See* Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do With It?*, 15 HOUSING POL'Y DEBATE 715, 715-16 (2004), *available at* http://www.mi.vt.edu/data/files/hpd%2015(3)/hpd%2015(3)_article_engel.pdf (describing relevance of holder in due course doctrine to subprime mortgage securitization); Cassandra Jones Havard, *To Lend or Not to Lend: What the CRA Ought to Say About Sub-Prime and Predatory Lending*, 7 FLA. COASTAL L. REV. 1, 16-18 (2005).

190. *See, e.g.*, Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2235-38 (2007) (describing exceptions to holder in due course doctrine).

191. *Id.* at 2236.

192. 15 U.S.C. §§ 1601-1615 (2006).

193. 15 U.S.C. §§ 1639, 1648.

194. *See* Engel & McCoy, *supra* note 187, at 2052-54 (describing, inter alia, TILA and HOEPA exemptions).

195. *See* Peterson, *supra* note 190, at 2239-40.

196. *See, e.g.*, Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 640 (2002) (arguing that the holder in due course is not necessary in residential mortgage loans); Siddhartha Venkatesan, Note, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. LEGIS. & PUB. POL'Y 177, 177

before Congress, which has passed the House of Representatives, would expand the TILA exceptions to the doctrine by authorizing rescission of a loan if it met the requirements for TILA rescission, even if the loan had been passed on to an assignee.[197]

I could not possibly add to the substantial body of scholarship that has attacked the holder in due course defense on historical, moral, practical, and/or doctrinal grounds.[198] Instead, when analyzing the incentives in place in the mortgage market that contributed to the present financial crisis, one must admit that the presence of the holder in due course doctrine, with its ability to shield investors from potential liability for the bad acts of the creators of the interests in which they invest, when coupled with the confidence in the interests the credit rating agencies generated, likely contributed to the ease with which capital flowed into subprime securities.

The holder in due course doctrine obviously creates incentives that facilitate the flow of capital to the instruments the doctrine covers. This flow can have positive and negative ramifications. Securitization of mortgages frees up mortgage capital to generate more mortgages, which, under normal conditions, would generally produce positive externalities. To the extent that the doctrine distorted the incentives and encouraged some lenders to promote mortgages they would normally not extend if they

---

(2003) (advocating an affirmative cause of action against predatory loan assignees).

197. *See* H.R. 1728, 111th Cong. § 204 (2009) (extending "limited" TILA liability to assignees and securitizers of loans under certain conditions).

198. The literature critiquing the holder in due course doctrine is extensive. *See* Countryman, *supra* note 186, at 10; Eggert, *supra* note 196, at 636; Engel & McCoy, *supra* note 187, at 730-31; Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 OR. L. REV. 1095, 1138 (1996); Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 461 (1979); Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951, 1007 (1997); Walter D. Navin, Jr., *Waiver of Defense Clauses in Consumer Contracts*, 48 N.C. L. REV. 505, 550 (1970); Albert J. Rosenthal, *Negotiability—Who Needs It?*, 71 COLUM. L. REV. 375, 375-76 (1971); Edward L. Rubin, *Learning from Lord Mansfield: Toward a Transferability Law for Modern Commercial Practice*, 31 IDAHO L. REV. 775, 776 (1995); M.B.W. Sinclair, *Codification of Negotiable Instruments Law: A Tale of Reiterated Anachronism*, 21 U. TOL. L. REV. 625, 625 (1990).

feared that they would face claims of fraud or discrimination, the doctrine should be discarded.

One approach to accomplish this end would require that all mortgage loans contain language similar to the language required by the Federal Trade Commission in contracts involving consumer goods and services. Such language makes such contracts "non-negotiable" for the purposes of the holder in due course doctrine, rendering them outside the doctrine's protections.[199] Another technique would include using limits on the doctrine to reduce the potential effects of social distance by exempting all claims against any financial instrument under the FHA and the ECOA, laws designed to proscribe discrimination in mortgage lending and other practices. Creating full exemption[200] of such provisions from the application of the doctrine would likely force the potential purchasers of instruments to police the underlying transactions better to ensure that they were not consummated in a discriminatory fashion, rather than simply turning a blind eye to the types of practices that were rampant during the height of the subprime mortgage market.[201]

3. *Credit Default Swaps.* Another area that is ripe for regulatory overhaul is the market in credit default swaps: essentially insurance policies that banks and investors purchased as a hedge against a downturn in the mortgage market and a reduction in the value of mortgage-backed securities. During the height of the subprime mortgage market, these instruments gave investors a false sense of security; not only did investors believe their investments were secured by assets, they also purchased insurance against the (perceived) unlikely event that the market experienced a downturn. Companies offering these

---

199. Preservation of Consumers' Claims and Defenses: Final Regulations, Proposed Amendment and Statement of Basis and Purpose, 40 Fed. Reg. 53,506, 53,512 (Nov. 18, 1975). For an analysis of this FTC Rule, see Peterson, *supra* note 190, at 2237-38.

200. Presently, the FHA and ECOA apply to assignees if they engaged in some form of discriminatory conduct with respect to the underlying loan, or knew or should have known of discriminatory conduct on the part of the seller of the instrument. *See* Peterson, *supra* note 190, at 2239-40.

201. For a discussion of the role of racial discrimination in subprime lending, see *infra* notes 250-53 and accompanying text.

instruments were more than willing to guarantee the health of housing market assets: insuring those assets, to some, must have seemed like insuring that the sun would rise in the morning. And perhaps the fact that investors and investment banks were relying on credit default swaps as a way to reduce the risk of their investments was a sign that they were acting irresponsibly and taking into account any doubts they had about the strength of the U.S. housing market.[202]

The problem with credit default swaps was that they turned out to be ephemeral, not worth the paper they were written on (unless, of course, the U.S. government decided to back them). It is hard to think of a financial instrument that is more a product of the deregulatory philosophy than credit default swaps. In essence, these were treated as derivatives when Congress chose to impose a regulatory regime on credit default swaps in particular and derivatives in general. Tragically, the regulatory regime Congress imposed was one of no regulation at all. In fact, with passage of the Commodity Futures Modernization Act, in the twilight of the Clinton Administration, and with bi-partisan support, Congress not only said that regulators could not regulate these instruments as insurance or as financial products[203] but also directed that such instruments could not even be regulated as gaming.[204] As a result, investors put their faith in credit default swaps even though any oversight of those instruments was expressly prohibited. The fallout from this misplaced trust, trust that had no recourse to the law when it turned out it was misplaced, has been severe, with its greatest impact falling on U.S. taxpayers, who ended up footing the bill for nearly $160 billion to back up AIG's CDS promises.[205] A philosophical bent towards deregulation thus generated a legal vacuum, one that was exploited when times were good, but ended up leading to financial ruin once the good times passed.

---

202. For an overview of the role of credit default swaps in increasing and encouraging risky investment practices, see POSNER, *supra* note 71, at 56-60.

203. Commodity Futures Modernization Act of 2000, 7 U.S.C. §§ 1-27f (2006).

204. *See* 7 U.S.C. 16(e)(2) (2006).

205. *See* Gretchen Morgenson, *A.I.G., Where Taxpayers' Dollars Go to Die*, N.Y. TIMES, Mar. 8, 2009, at BU1.

The Obama Administration has set forth a series of principles that should reform the regulation of credit default swaps and other derivatives, these include the following: the development of standardized and regulated trading platforms; the imposition of capital requirements for issuers of derivatives; the introduction of mechanisms to improve transparency of derivatives; and the identification of clear regulatory authority over the derivatives market.[206] The need for rules and oversight in the derivatives market cannot be overstated.[207] The absence of such rules had tragic consequences for the financial system, creating the sense of deep uncertainty and crisis in the late summer/early fall of 2008. It is obvious that regulation of this sector of the financial system is desperately needed. The types of reforms proposed by the Obama Administration seem to reflect the types of conditions that are likely to generate trustworthy behavior, and are thus worthy of serious consideration: the imposition of oversight, regulation and capital requirements would all seem to have the effect of reining in the riskiest behavior within this market, fostering trust and encouraging trustworthiness.

B. *Reputation and Repeat Play*

As stated earlier, one of the forces that can encourage greater cooperation is the extent to which parties are engaged in a series of transactions, and rely on each other's willingness to cooperate to encourage greater cooperative behavior in the aggregate. This can include both two-party games, where parties generate trust among each other to increase cooperative behavior between them, and situations involving many participants, where individuals are members of groups and wish to develop reputations as cooperative members within such groups. If one cheats another member of that individual's group, there is the fear that information shared within the network of members will discourage others from trading with the cheater, limiting

206. *See Joint Hearing on Regulation of Over the Counter Derivatives Before the H. Comm. on Financial Services and the H. Comm. on Agriculture*, 111th Cong. (2009) (testimony of Timothy Geithner, Secretary, U.S. Dep't of Treasury) [hereinafter Geithner Testimony]; *see also Obama Plan*, *supra* note 3, at 46-51.

207. According to Secretary Geithner, the value of the derivatives market in 2008 was nearly three-quarters of a quadrillion dollars. *See* Geithner Testimony, *supra* note 206.

his or her trade opportunities. Thus, individuals engaged in activity with others that is more likely to be repeated, where knowledge networks will spread information about the trustworthiness of those individuals, are more likely to behave in a trustworthy fashion.

Financial institutions, as organizations, engaged in a wide range of risky—and to a great extent, untrustworthy—behavior during the height of the era of easy credit. But not all financial institutions are worthy of blame, and even some of the most untrustworthy, it turns out, engaged in sensible behavior in certain areas. Indeed, two examples from the lead up to the financial crisis reveal these phenomena, and make the case that informal norms and reputational effects likely served as robust checks on predatory conduct, even in a time of loosening standards and weak controls on such conduct.

The first example is the functioning of small and community banks during the height of the subprime frenzy.[208] While some local banks became conduits for the

---

208. *See generally The Effects of the Economic Crisis on Community Banks and Credit Unions in Rural Communities: Hearing Before the Financial Institutions Subcomm. of the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. (2009) [hereinafter *The Effects of the Economic Crisis on Community Banks and Credit Unions in Rural Communities*] (statement of Peter Skillern, Executive Director of the Community Reinvestment Association of North Carolina) (testifying to the "stability small banks have provided" in rural areas during the financial crisis as they largely steered clear of subprime lending); *id.* (statement of Ed Templeton, President/CEO of SRP Federal Credit Union on behalf of The National Association of Federal Credit Unions) (asserting that credit unions, unlike large financial institutions, remained free from entanglement in the subprime lending crisis); Phillip Longman & T. A. Frank, *Too Small to Fail*, WASH. MONTHLY, Nov./Dec. 2008, at 14, 14-15 [hereinafter Longman & Frank, *Too Small*] (citing specific examples of community banks that stayed away from subprime lending and are doing well as a result); *see also* Greg Bordonaro, *Local Banks See Uptick in Activity*, HARTFORD BUS. J., Oct. 20, 2008, http://hartfordbusiness.com/news6900.html (explaining that small, local banks are assuring customers they are separate from the turmoil in financial markets and your money is safe); Katie Zezima, *Vermont Bank Thrives While Others Cut Back*, N.Y. TIMES, Nov. 8, 2008, at B4 ("While many of the nation's large and midsize banks are staggering under the weight of bad mortgages piled up during the housing boom, the First National Bank of Orwell, Vermont's smallest bank . . . is having its best year in recent memory."); Press Release, Indep. Cmty. Bankers of Am., ICBA statement on FDIC Quarterly Bank Report (Aug. 22, 2007), http://www.icba.org/news/newsreleasedetail.cfm?ItemNumber=37054&sn.ItemNumber=1733&tn.ItemNumber=1915 ("[C]ommunity banks have strong deposit growth, have maintained solid underwriting standards, have

securitization process, offering up their residential loans to the larger investment banks in an effort to access the securitization cash machine, many small financial institutions, rooted in their communities, did not engage in risky lending behavior, did not lower their underwriting standards, and were motivated by concerns for their reputations within the communities they served. Many were motivated to maintain and preserve long-term customer relations with their clients and attract more prospective clients that would, in turn, become long-term customers as well.[209] Many small banks practiced the boring art of taking

---

healthy collateral, and have had little or no exposure to subprime lending. They are among the most highly regulated financial institutions in the nation."); Video: Phillip Longman & T. A. Frank, Community Banks to the Financial Rescue, (New Am. Found. Op-Ed Video Nov. 20, 2008), *available at* http://www.newamerica.net/publications/special/save_americas_finances_bring_back_community_banking_8399 [hereinafter Longman & Frank Video Op-Ed] (describing the positive practices and effects of community banking).

209. *See The Effects of the Economic Crisis on Community Banks and Credit Unions in Rural Communities, supra* note 208 (statement of Frank Michael, President and CEO, Allied Credit Union on behalf of the Credit Union National Association) ("The maintenance of . . . ownership interest means that credit unions care deeply about what ultimately happens to the loans they originate—they care if the loans are paid back. The sub-prime crisis, in contrast, has been closely linked to lenders who . . . cared little about repayments because the quality of the loans they sold became someone else's problem."); Kevin Coyne, *Small Banks Stay Snug, Like the Fabled Ant*, N.Y. TIMES, Oct. 19, 2008, at NJ2 (attributing the success of small banks in avoiding the financial crisis to "[s]taying small and staying home"); Longman & Frank, *Too Small, supra* note 208, at 16 ("When savers, borrowers, and lenders all live in the same community . . . [lenders] know their business depends on their good reputation. Similarly, borrowers, who prize the good opinion of their neighbors, don't easily walk away from their loans."); David Pevear, *Bank On It: Your Cash Is Safe*, SUN (Lowell, Mass.), Oct. 17, 2008, at A1 ("[Local banks] bring in local deposits and lend out locally, one loan at a time, to qualified borrowers with whom they develop face-to-face relationships . . ."); Kevin Post, *Local Banks Tell Customers: Your Money Is Safe*, PRESS OF ATLANTIC CITY, Sept. 18, 2008, at C4 ("The reality is, when you keep your money close to home in a community bank, you're safe and sound."); Christina Rexrode, *Small Banks Buck Subprime Downturn*, CHARLOTTE OBSERVER, Feb. 2, 2008, at 1D (noting that local community banks "'know their lenders in many ways, not just information on a form that was faxed to them from somebody somewhere else in the country.'" and that community bankers take great care in lending because they "'work, . . . go to church, [and] go to school with the people in our community. We would not want to make a loan to someone that they could not repay at a later date.'"); David Segal, *We're Dull, Small Banks Say, and Have Profit to Show for It*, N.Y. TIMES, May 12, 2009, at A1 ("Forget 'too big to fail.' These banks consider themselves too small to risk

deposits from the communities they served and lending such deposits out to borrowers in those same communities.[210] They were able to assess the creditworthiness of their customers because they had repeat dealings with them: perhaps making a car loan one day, opening a small business line of credit the next, and opening up a college savings fund the day after that.[211] Such bankers stuck to conservative underwriting principles,[212] benefited from the information they could gather about their customers' creditworthiness because of repeated transactions with them,[213] and made lending decisions based

---

embarrassment. They are run by people who grew up in the towns where they work, and their main fear is getting into a financial jam that will shame them in the eyes of their neighbors.").

210. *See* Teresa Dixon Murray, *The Little Banks That Could*, PLAIN DEALER (Cleveland), July 6, 2008, at D1 (detailing the conservative lending strategies of three small, local banks that kept them from being enmeshed in the subprime meltdown); Segal, *supra* note 209 ("'Banking should not be exciting . . . . If banking gets exciting, there is something wrong with it.'" (quoting Clay W. Ewing, President of Retail Financial Services at German American Bancorp.)).

211. *See, e.g.*, Murray, *supra* note 210 (knowledge of customers allows lenders to assess whether a borrower will be able to repay a loan); Adam Serwer, *Banks as Heroes*, AM. PROSPECT, July/Aug. 2009, at A18 (stating that because community banks know their customers via long-term relationships they are able to accurately evaluate credit-worthiness); Zezima, *supra* note 208 ("'There's serious value in looking someone in the eye and understanding what their drive is, where they're coming from and how serious they are about the project.'" (quoting Bryan Young, Vice President of First National Bank of Orwell)).

212. *See, e.g.*, Joseph Berger, *Money Lending, the Old-Fashioned Way*, N.Y. TIMES, Apr. 26, 2009, at WE1 (detailing the "old-fashioned," "'conservative,'" "common-sense" practices of a "'plain-vanilla bank'" strongly linked to its local community); Eric Dash, *Caution Pays for a Lender in New Jersey*, N.Y. TIMES, Aug. 14, 2008, at C1 (explaining the success of a small bank that stuck to the basics, "preferring to operate as a mom-and-pop boutique instead of a financial department store[,]" and was careful in evaluating borrowers before making loans); Murray, *supra* note 210 ("[B]anks that haven't gotten pummeled by mortgages have something in common: They were conservative with their lending . . . earlier this decade when most banks were falling all over themselves to make every loan possible."); Posting of Ryan Goldberg to Top Stocks, http://blogs.moneycentral.msn.com/topstocks/archive/2009/07/21/the-best-little-bank-in-america.aspx (July 21, 2009) (asserting that adhering to conservative lending principles kept Sunwest Bank in Orange County, California out of the subprime lending mess, resulting in current strong growth and potential).

213. *See* Murray, *supra* note 210 (citing a bank where every loan application is reviewed by the head officers of the institution before being granted or denied); Jim Rendon, *Rusty Cloutier Has Money to Spare*, N.Y. TIMES, May 17, 2009, at

on the viability of these customers as credit risks over the long-term because they wanted a long-term relationship that would generate more business over time with these customers.[214] For the most part, bankers that stuck to this approach have been able to avoid the worst of the fallout from the financial crisis because they reacted to, and took into account, the forces similar to those that inform our understanding of how repeat players in prisoner dilemma games tend to behave: when one cares about one's reputation, and one wants to pursue a cooperative relationship over the long-term, one is more likely to behave in a trustworthy fashion. Trustworthy conduct leads to trust, and that trust has an economic payoff, especially for the merchant looking to maintain and foster strong and repeat trading relationships with customers.[215]

MM28 (suggesting that knowing one's customers is the key to successful lending); *see also* Phillip Longman & Ellen Seidman, *To Save America's Finances, Bring Back Community Banking*, NEW AM. FOUND., Nov. 20, 2008), http://www.newamerica.net/publications/special/save_americas_finances_bring_back_community_banking_8399 [hereinafter Longman & Seidman, *To Save America's Finances*] ("[S]mall-scale banking means that savers, borrowers, and lenders all have a heightened ability to judge each other's character and to hold each other accountable. . . . [S]mall-scale banks are rich with what Federal Reserve Chairman Ben Bernanke calls 'informational capital,' which they develop through 'gathering relevant information, as well as by maintaining ongoing relationships with customers.' Or as the Federal Reserve Bank of Dallas put it . . . in a 2004 report: . . . 'the most relevant indicators regarding the creditworthiness of individual small businesses still take the form of firsthand information gained through close lender-borrower relationships.'").

214. *See, e.g.*, Rexrode, *supra* note 209 ("Community banks . . . [are] more concerned than many mortgage orginators about keeping customers for the long term."); Segal, *supra* note 209. Segal quotes a saying heard among community bankers in Indiana that "We want to be around for decades, so we're not focused on the next quarter." Segal, *supra* note 209.

215. *See* Bordonaro, *supra* note 208 ("'Public confidence' is a crucial issue,' said Bill McGurk, CEO and president of Rockville Bank. 'Banks need to reach a sense of trust with their depositors.'"); *see also* Longman & Frank, *Too Small*, *supra* note 208 (suggesting that banks closely tied to their community have a vested interest in promoting the well-being of that community, and this is reflected in their financial practices); Rendon, *supra* note 213 (describing how conservative, relationship-based banking practices have resulted in profits and the solvency to keep lending during the current financial situation); Serwer, *supra* note 197 (explaining that the community-focused practices of ShoreBank has positioned it to offer help to people suffering as a result of the subprime crisis); Longman & Seidman, *To Save America's Finances*, *supra* note 213 (suggesting that "relationship banking" and the other practices of small,

Another subject that has received a great deal of attention over the last year has been what role, if any, did the Community Reinvestment Act (CRA)[216] play in the financial crisis. Some commentators have argued that the CRA forced banks to make unwise loans to risky borrowers; and when those borrowers defaulted on those loans, those defaults triggered the financial crisis.[217] Such a line of argument might offer succor to those who would prefer to lay the blame for the financial crisis on a fairly modest law, one that was passed thirty years before the financial crisis began to unfold, than to acknowledge the wrongdoing that was truly at the heart of the present crisis. Moreover, such an argument cannot be squared with the stark reality that the CRA was largely irrelevant to the financial crisis, mostly because it covered only a tiny fraction of the subprime loans consummated during the subprime mortgage market's heyday. In fact, an analysis of the effect of the CRA on bank lending activity actually shows that lending that was covered by the CRA was far more stable than that which was not covered by the CRA, even when such different types of lending were carried out by the very same bank. Given that this modest law had little bite, particularly over the last decade and regulators were loathe to enforce it vigorously, one can look at the informal effect the law had on bank conduct in a deregulatory environment to test some of the theories of informal controls. To do that, some background on the law is in order.

The CRA was passed in 1977 to authorize federal bank regulators[218] to use their authority to "to *encourage*

---

community banks be used as a model for moving beyond the current financial crisis and for preventing the next one).

216. 12 U.S.C. §§ 2901-2908 (2006).

217. *See*, e.g., Howard Husock, *Housing Goals We Can't Afford*, N.Y. TIMES, Dec. 10, 2008, at A49 ("Banks were [sic] now being judged not on how their loans performed but on how many loans they made. This undermined the regulatory emphasis on safety and soundness."); Charles Krauthammer, *Catharsis, Then Common Sense*, WASH. POST, Sept. 26, 2008, at A23 ("[The CRA] led to tremendous pressure on Fannie Mae and Freddie Mac—which in turn pressured banks and other lenders—to extend mortgages to people who were borrowing over their heads.").

218. The regulators, and the types of financial institutions they each regulate, are as follows: the Office of the Comptroller of the Currency applies the law with respect to national banks; "the Board of Governors of the Federal Reserve System with respect to State chartered banks which are members of the Federal

[financial] institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."[219] Federal bank regulators grade covered banks on their overall performance in meeting their CRA obligations.[220] This record of performance is taken into account when banks seek approval of certain transactions.[221] The CRA is also "enforced" by private actors, when citizens and community groups file CRA "challenges" or "protests" at the time a financial institution applies to its regulators for approval of any transaction covered by the CRA.[222] At the end of the day, the regulators have the final say over whether a financial institution's application should be approved either in light of, or despite, their record of meeting community credit needs.

What is almost as important as what the CRA covers is what it does not cover. The CRA does not apply to the following entities and transactions: mortgage lending carried by non-depository institutions, a bank's activities outside of its CRA assessment area (i.e., where it receives its deposits or where a large percentage of its lending takes place); bank activities carried out by the subsidiaries of depository institutions, if those covered institutions elect not to have the conduct of their subsidiaries assessed for

---

Reserve System and bank holding companies;" the Federal Deposit Insurance Corporation "with respect to State chartered banks and savings banks which are not members of the Federal Reserve System and the deposits of which are insured by the Corporation;" and the Office of Thrift Supervision with respect to savings association, "the deposits of which are insured by the Federal Deposit Insurance Corporation" and savings and loan holding companies. 12 U.S.C. § 2902(1).

219. *Id.* § 2901(b) (emphasis added).

220. As a result of these examinations, banks are given one of four "ratings" based on the evaluations conducted: "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance." *Id.* § 2906(b)(2).

221. *Id.* § 2903(a). These transactions include applications for any of the following: "a charter for a national bank or Federal savings and loan association;" "deposit insurance in connection with a newly chartered . . . bank;" the opening of a branch or other facility that will accept deposits; the relocation of a home or branch office; or the merger, consolidation, or acquisition of another regulated financial institution in certain circumstances. *Id.* § 2902(3).

222. *See* Richard D. Marsico, *The New Community Reinvestment Act Regulations: An Attempt at Implementing Performance-Based Standards*, 49 CONSUMER FIN. L.Q. REP. 47, 48 (1995).

compliance with the CRA; and lending to individuals who are not of low- or moderate-income.[223] As the following discussion shows, it is these exemptions that rendered the overwhelming majority of subprime lending carried out during the height of the subprime mortgage market beyond the scope of the CRA.

Over its relatively brief history, the CRA has worked effectively to bring credit to communities that banks and other financial institutions traditionally failed to serve.[224] And even during the height of the subprime mortgage market, CRA-related lending outperformed other types of lending in many respects. A recent study conducted by the Board of Governors of the Federal Reserve System of CRA-related lending in 2005-2006 showed that borrowers connected to CRA-related loans were half as likely to fall behind on their mortgage payments as subprime borrowers.[225] This study also showed that with respect to

223. For an in-depth look at the exemptions that made the CRA largely irrelevant to the overwhelming majority of subprime lending, see Raymond H. Brescia, *Part of the Disease or Part of the Cure: The Financial Crisis and the Community Reinvestment Act*, 60 S.C. L. REV. 617, 642-45 (2009).

224. *See, e.g.*, Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513, 566 (2005) ("[T]he CRA and their affiliates made nearly $620 billion in home mortgage, small business, and community development loans to low- and moderate-income borrowers and communities."); Douglas D. Evanoff & Lewis M. Segal, *CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending*, ECON. PERSP., Nov./Dec. 1996, at 19; Lewis M. Segal & Daniel G. Sullivan, *Trends in Homeownership: Race, Demographics, and Income*, ECON. PERSP., 2d Quarter 2008, at 53, 68 (finding CRA lending reduced minority homeownership rate gap during two year period between 1995-1997); ERIC S. BELSKY ET AL., JOINT CTR. FOR HOUS. STUDIES, HARVARD UNIV., THE EFFECT OF THE COMMUNITY REINVESTMENT ACT ON BANK AND THRIFT HOME PURCHASE MORTGAGE LENDING (2001), http://www.jchs.harvard.edu/publications/governmentprograms/belschillyezer_cra01-1.pdf; JOINT CTR. FOR HOUS. STUDIES, HARVARD UNIV., THE 25TH ANNIVERSARY OF THE COMMUNITY REINVESTMENT ACT: ACCESS TO CAPITAL IN AN EVOLVING FINANCIAL SERVICES SYSTEM 48, 53-54 (2002), http://www.jchs.harvard.edu/publications/governmentprograms/cra02-1.pdf (indicating that prime mortgage lending carried out in minority communities was the strongest when carried out by banks acting within their CRA assessment areas); ROBERT E. LITAN ET AL., U.S. DEP'T OF THE TREASURY, THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A BASELINE REPORT, ES-5 chart ES-5, 70 chart 14, 74 chart 16 (2000), http://www.treas.gov/press/releases/docs/crareport.pdf.

225. Memorandum from Glenn Canner & Neil Bhutta, Div. of Research and Statistics, Bd. of Governors of the Fed. Reserve Sys. to Sandra Braunstein, Dir.,

foreclosures in the second quarter of 2008, non-CRA, subprime borrowers were *twenty times* more likely to end up in foreclosure than borrowers in a CRA-related program.[226]

If lending under the CRA has proven so effective in encouraging banks to make sound loans, how is it that the subprime mortgage market was able to spin out of control? If CRA-covered loans were not at as great a risk of default as subprime loans generally, why have we found ourselves in the current crisis, with default rates in California and Florida hovering around ten percent? Simply put, because of the many loopholes discussed above—that mortgage lenders, bank subsidiaries, and lending outside of bank CRA assessment areas are all outside the scope of the CRA—the CRA was basically irrelevant to the overwhelming majority of subprime lending during the peak of that market and a recent Federal Reserve study bears this out. Indeed, reviewing loans made in 2005-2006, the Fed determined that the CRA covered only 6% of all higher-priced loans (the Federal Reserve's proxy for subprime loans).[227]

Looking at the CRA as a formal, third-party control on bank conduct, the formal mechanisms within the law appear rather weak. Since bank regulators are supposed to take into account the extent to which covered financial institutions are meeting the credit needs of the communities they serve, one would expect that the records of those institutions during a period of aggressive and risky banking, particularly in low- and moderate-income communities, would have caused banks to receive low grades under the CRA. The contrary is true, however. The examination process has yielded few low grades, as over 98% of banks now receive either an "outstanding" or "satisfactory" score, and this figure has increased

Consumer & Cmty. Affairs Div., Bd. of Governors of the Fed. Reserve Sys. 10 tbl.7 (Nov. 21, 2008), http://www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf; *see also* Lei Ding et al., Ctr. for Comty. Capital, Univ. N.C., Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models 1 (Dec. 2008) (working paper, on file with the University of North Carolina Center for Community Development), *available at* http://www.ccc.unc.edu/documents/RiskyMortg_Final_Dec11.pdf (showing better performance of CRA-related loans as compared to non-CRA-related subprime loans even with borrowers of similar income and creditworthiness).

226. Canner & Bhutta, *supra* note 225, at 10.

227. *Id.* at 3.

significantly over the last twenty years.[228] In 1990, just under 10% of banks received either a score of "needs to improve" or "substantial noncompliance."[229] Between 1990 and 1994, the number dropped to just over 5%.[230] During the height of the subprime mortgage market, the figures were 0.7% for 2003, 0.8% for 2004, and 1.0% for 2005.[231]

Since the examination process seems to have become a rote affair, perhaps it is at the application approval process that the CRA bares its teeth. Unfortunately, that is not the case either. From 1985 through 1999 (a period before the rapid expansion of the subprime market), less than 0.8% (692 out of 92,177) of bank applications subject to the CRA received any adverse comments, either on CRA or other grounds.[232] Only 8 applications of these 692 in which adverse comments were received were denied for any reason.[233] At the end of the day, 8 out of 92,177 bank applications were denied on any grounds (or less than .01% of all bank applications) during this fifteen-year period.[234] More recent evidence from applications before the Federal Reserve reveals that that body received 13,500 bank applications from 1988 through May 2007, and only 8 of them, less than .06%, were denied on grounds described as "unsatisfactory consumer protection and community needs issues."[235]

If these formal mechanisms are not the source of the CRA's success, then informal forces must be at work. Richard Marsico has identified four factors that motivate

---

228. *The Community Reinvestment Act: Thirty Years of Accomplishments, but Challenges Remain: Hearing Before the H. Comm. on Financial Servs.*, 110th Cong. 194 (2008) (statement of John Taylor, President & Chief Executive Officer, National Community Reinvestment Coalition).

229. *Id.*

230. *Id.*

231. *Id.*

232. Barr, *supra* note 224, at 586 (citing TREASURY DEP'T, APPLICATIONS SUBJECT TO CRA THAT WERE PROTESTED ON CRA GROUNDS (2000)).

233. *Id.*

234. *Id.*

235. *Foreclosures at the Front Step of the Federal Reserve Bank of Cleveland: Hearing Before the Subcomm. on Domestic Policy of the H. Comm. on Oversight and Government Reform*, 110th Cong. 63-64 (2007) (statement of Sandra Braunstein, Director, Division of Consumer and Community Affairs).

banks to take their CRA records and the community group challenges to their applications seriously: that banks are concerned that their applications will be denied; that the delay associated with a challenge will undermine the underlying transaction; that the transaction costs associated with defending the challenge will be high, and that the bad publicity that might arise in the course of a challenge—including, for example, allegations that a bank discriminates against a particular community—will drive away customers and even send stock prices down.[236]

These forces are all very real and often lead banks to enter into CRA agreements settling CRA challenges and, at least according to one analysis, such agreements have led to as much as $6 trillion in lending in low- and moderate-income communities since the inception of the CRA.[237] Given the remarkably small number of bank applications that are denied on CRA grounds and the remarkably high number of banks that receive passing grades under the CRA, these third party controls—denial of bank applications, the CRA ratings process—are clearly extremely weak. It is unlikely that banks are influenced greatly by the threat of application denials or low CRA ratings. Instead, what seems to be the most powerful forces that likely do the most to "encourage" banks to honor their CRA commitments are internalized norms through which bank managers believe they should honor these commitments (because of first order constraints), and the very real threat that their reputation will be harmed by negative CRA publicity should community members file a challenge to a bank's application (an example of informal third party constraints).[238] It is obvious then, that the CRA, given the impressive performance record of CRA-related lending during the expansion of the subprime market when compared to subprime lending in that market during that time, is an effective tool for promoting trustworthy behavior, even though it utilizes "soft" controls, like internalized norms

236. RICHARD D. MARSICO, DEMOCRATIZING CAPITAL: THE HISTORY, LAW, AND REFORM OF THE COMMUNITY REINVESTMENT ACT 133 (2005) (citations omitted).

237. NAT'L CMTY. REINVESTMENT COAL., CRA TOOLKIT: PROTECTING AND PRESERVING THE COMMUNITY REINVESTMENT ACT 2 (2008), https://salsa.democracyinaction.org/o/2249/images/cra%20toolkit_v5.pdf.

238. MARISCO, *supra* note 236, at 133.

and informal, external constraints.[239] The relationship between CRA performance and bank reputation in the community is the likely strongest control the CRA imposes on banks to rein in predatory conduct. The value of this type of reputational control is taken up again in the concluding section below.

Congress is presently considering whether to close the loopholes described above that place much mortgage lending beyond the reach of the CRA and expand its coverage to other financial sectors, including the securities and insurance industries.[240] The effectiveness of the CRA is obvious, and its expansion makes a great deal of sense: both to encourage compliance with formal norms, but also to elicit responses to informal controls that can channel pro-social behavior effectively.

C. *Consumer Education, Improved Communication Between Borrower and Lender and Transparency*

Some argue that, moving forward, better consumer education can improve the transparency of mortgage products and limit the ability of brokers and lenders to exploit asymmetries of information in the mortgage market

---

239. *See, e.g.*, Elizabeth Laderman & Carolina Reid, *Lending in Low- and Moderate-Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown* (Fed. Reserve Bank of S.F., Working Paper No. 200805, 2008), *available at* http://www.frbsf.org/publications/community/wpapers/2008/wp08-05.pdf. In this study, the authors used data on over 200,000 mortgages made in metropolitan California markets from 2004-2006, which corresponds to the subprime explosion in California, to show the CRA was not a cause of the crisis based on how the examined CRA regulated loans performed at least as well as, if not usually significantly better than, non-CRA loans. CRA loans made within the bank's area of operation were roughly half as likely to be in foreclosure as those made by an independent mortgage company (IMC) which did not have to follow CRA guidelines and that loans made by wholesalers, typically not covered by the CRA, were at least twice as likely to be in foreclosure. *Id.* at 7-8, 17-20, tbl.20; *see also* TRAIGER & HINCKLEY LLP, THE COMMUNITY REINVESTMENT ACT: A WELCOME ANOMALY IN THE FORECLOSURE CRISIS (2008), http://www.traigerlaw.com/publications/traiger_hinckley_llp_cra_foreclosure_study_1-7-08.pdf ("CRA banks were substantially less likely than other lenders to make the kinds of risky home purchase loans that helped fuel the foreclosure crisis.").

240. *See* Community Reinvestment Modernization Act of 2009, H.R. 1479, 111th Cong. (2009)

between such actors and prospective mortgage customers. One of the main proponents of this approach is Robert Shiller, who believes that improved consumer education would put consumers on an equal footing with the financial industry representatives with which they come in contact, improving the ability of consumers to shop effectively in the market for the financial products that best meet their needs and interests.[241]

Would effective consumer education have helped to prevent the present financial crisis? Would it have reduced the number of borrowers who would have pursued complex, adjustable rate mortgages that were like ticking time bombs? Would a better sense of the functioning of real estate markets, and their tendency to rise and fall cyclically, have prevented overconfidence in that market? Did this overconfidence tend to encourage borrowers to pursue such products as adjustable rate mortgages out of the belief that they could refinance that mortgage (because of ever increasing home values) before the interest rate reset? Evidence from at least one state tends to show that consumer education of a sort may have made a difference in preventing the predation that was rampant in many communities.

Vermont has avoided most of the worst impacts of the financial crisis.[242] It routinely comes in low on any of the indicators of housing market distress: presence of subprime mortgages, delinquencies, and foreclosures.[243] With a high

241. *See* SHILLER, *supra* note 76, at 123 ("The first step in correcting this failure of public education is to promote comprehensive financial advice for everyone through institutions that will make sure that all individuals, not just the most wealthy, receive such advice."); *see also* Richard H. Thaler & Cass R. Sunstein, Op-Ed, *Economic Policy for Humans*, BOSTON GLOBE, Apr. 17, 2008, at A13 (arguing that the complexity involved in mortgage process led to uninformed decisions by consumers and that more transparency to allow informed decisions is needed in the future to avoid a similar situation developing).

242. *See* PAULETTE J. THABAULT, VT. BANKING COMM'R, ANNUAL REPORT OF THE BANK COMMISSIONER 1 (2009), http://www.bishca.state.vt.us/BankingDiv/annual_report/MI-1.pdf (noting that while Vermont has not been "immune to the rise in foreclosures" consistent with national trends, fewer than 1700 new foreclosure filings were reported in calendar year 2008 in that state).

243. As of August 26, 2009, RealtyTrac had noted that there were a total of 61 new foreclosure filings in Vermont for all of calendar year 2009. RealtyTrac,

home ownership rate at the beginning of the Presidency of George W. Bush, one could certainly argue that there was little room for aggressive lending and borrowing. One could also argue that a culture of Yankee frugality might have prevailed in Vermont, which could have led to less speculation and fewer borrowers pursuing larger homes or seeking to draw on the equity in their present homes to purchase consumer goods.[244] Or one could look to the legal infrastructure to determine the extent to which the laws on Vermont's books at the time might have prevented the crisis from hitting hard in that state.

An analysis of the legal infrastructure in Vermont shows that an important law in place during the growth of the subprime mortgage market may have helped that state avoid some of the worst fallout from the mortgage crisis. In that state, whenever a mortgage broker or lender attempts to extend a loan that is more than 3 points above the "declared" interest rate for the state (a yearly average of the interest rate banks charge each other to borrow money), or if the lender plans to charge the borrower 4 points or more to close the loan, the lender must inform the borrower that he or she might be able to obtain a loan with a lower interest rate, fewer points, or both, and inform the borrower that he or she can contact the state banking department to obtain a list of other loan companies.[245] This law tends to do

---

Vermont Trends, http://www.realtytrac.com/STATES/Vermont.html (last visited Aug. 26, 2009).

244. *See* Brian K. Sullivan, *Vermont Foreclosures Held Off By Yankee Ways, Land Use Laws*, BLOOMBERG.COM, Jan. 29,2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=afvnBtrN0HSk# (noting culture of frugality may have contributed to low level of foreclosures in Vermont); *see also*, Katie Zezima, *Vermont Bank Thrives While Others Cut Back*, N.Y. TIMES, Nov. 8, 2008, at B4.

245. VT. STAT. ANN. tit. 9, § 104 (1997). The state has issued regulations pursuant to the disclosure law, which can be found at Regulation B-98-2, "High Rate, High Point Notices for Residential Real Estate Loans." Section 3 of the regulations provides as follows:

Section 3. Content of Written Disclosure

The Disclosure shall:

A. Contain the following notice in uppercase letters and in a size equal to at least 14 point bold type and otherwise distinguishable from all other text of the Disclosure:

three things: it alerts borrowers to the fact that their broker might not be offering the best deal; it encourages borrowers to shop around for better loan terms; and it operates as an interest rate "ceiling", discouraging lenders from offering higher interest loans for fear that the borrower will be driven to other lenders because of the mandatory disclosure requirements.[246]

Trust and social capital are also high in Vermont.[247] Could the strength of networks of trust and trustworthy behavior have triggered lower rates of subprime mortgages because borrowers had long-term relationships with lenders, and such lenders were more interested in maintaining relationships with their borrowers than making a fast buck? According to Governor James Douglas, this may have also been another reason why Vermont has experienced low delinquency and foreclosure rates: "People know each other, know their banker. Lenders are able to make a good judgment."[248]

> YOU MAY BE ELIGIBLE FOR A LOAN WITH EITHER A LOWER INTEREST RATE, FEWER POINTS, OR BOTH, FROM ANOTHER LENDER.
>
> B. Inform the borrower(s) that they are applying for a loan with an interest rate that exceeds the Declared Rate by more than 3 percent and/or for which the lender shall charge more than 4 points.
>
> C. Include a statement informing the borrower(s) that they can obtain a list of other lenders by calling or writing to the Department of Banking, Insurance, Securities and Health Care Administration (the "Department's"), including the Department's telephone number and mailing address.
>
> D. Be signed and dated by the lender and all borrowers to be obligated under the note.

B-98-2 VT. CODE R § 3 (1999).

246. *See* Sullivan, *supra* note 244 (quoting Tom Candon, Deputy Commissioner of the Vermont Banking, Insurance, Securities & Health Care Department).

247. PUTNAM, *supra* note 37, at 293 fig.80.

248. Sullivan, *supra* note 244 (quoting James Douglas, Governor of Vermont).

What can we learn from the Vermont experience, with a legal infrastructure that encouraged consumer education and discouraged predatory conduct? In trying to discern the source of Vermont's success at largely avoiding the worst of the subprime crisis, can we tease out the role social capital and trust and Yankee ways played in the Vermont market to determine whether social forces and norms were a greater determinant of fiscally sound conduct than law? Probably not. It is likely that the disclosure law both discouraged predatory conduct because lenders did not want to offer loans that would trigger the disclosure requirement for fear of losing business and instilled confidence in the borrower that the loan terms offered were fair and consistent with the market (because they did not trigger the disclosure law).

It is likely impossible to find definitive evidence of the reasons Vermont has largely escaped the worst of the foreclosure crisis. For the disclosure law to have given borrowers confidence in the lender when the triggering interest rates or points were not present, those borrowers would have had to have known of the law's existence. Without information on borrower knowledge of the law, it is difficult to say what effect the law had on those borrowers. Moreover, some borrowers, when a lender offered them a loan with features that triggered the disclosure law, might have felt comforted by the fact that the lender was willing to inform the prospective borrower that he or she could seek a list of other lenders. This alone might have, instead, triggered a borrower's belief that the lender must not have anything to hide. The borrower might have decided to stay with the lender as a result, despite the disclosure. Without in-depth empirical research on this point, it is impossible to say definitively what effect the disclosure law had on foreclosure and delinquency rates.

Nevertheless, the perceptions of critical players in the Vermont market suggest that the law likely discouraged predatory conduct and improved consumer education when triggered.[249] This consumer education, coupled with conservative underwriting and lending practices, likely spared Vermont the harshest effects of the crash of the subprime mortgage market. Vermont thus opens a window into a setting in which law seems to have mattered and

249. *See id.*

consumer education seemed to serve important ends because it minimized information asymmetries and discouraged predatory conduct.

D. *Reducing Social Distance: Strong Enforcement of Anti-discrimination Laws and Limits on Executive Pay*

During the height of the subprime mortgage market, borrowers of color were more likely to be saddled with subprime loans. As one Federal Reserve study of mortgage lending carried out in 2006 revealed, more than 50% of loans to African Americans were high cost loans, while just under 18% of loans to Whites were high cost.[250] Even controlling for income and creditworthiness, African Americans were nearly twice as likely to have high cost loans as Whites of similar income.[251] The numbers are similar for Latinos as well; controlling for these same factors, Latinos were likely to enter into a subprime home purchase loan 24% of the time, as compared to the original figure of 17.7% for Whites.[252] A study conducted by the New York Times of subprime lending patterns in the New York City metropolitan region showed that middle income African Americans were five times more likely to enter into subprime loans than Whites of similar or even lower income.[253]

Private litigants have pursued several lawsuits alleging discriminatory pricing of subprime loans: i.e., that borrowers of color were given loans on less favorable terms than white borrowers, and several of these cases have already passed the motion to dismiss phase.[254] Municipal

---

250. Robert B. Avery et al., *The 2006 HMDA Data*, 93 FED. RES. BULL. A73, A95 (Fed. Res. Bank) (2007), http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf.

251. *Id.* at A95-96.

252. *Id.* at A96.

253. Michael Powell & Janet Roberts, *Middle Class Suffers—Neighborhoods are Devastated*, N.Y. TIMES, May 16, 2009, at A1 ("In New York City, for example, black households making more than $68,000 a year are almost five times as likely to hold high-interest subprime mortgages as are whites of similar—or even lower—incomes.").

254. *See, e.g.*, Taylor v. Accredited Home Lenders, Inc., 580 F. Supp. 2d 1062 (S.D. Cal. 2008); Miller v. Countrywide Bank, N.A., 571 F. Supp. 2d 251 (D. Mass. 2008).

government litigants have pursued actions against lenders for the promotion of subprime mortgage securitization, for their failure to maintain foreclosed properties, and for allegedly marketing and selling subprime products to borrowers along racial lines. In the first round of decisions in these types of cases, the municipalities have drawn a tie: Cleveland's action, which attempted to frame subprime securitization as a common law nuisance, was recently thrown out of court, while Baltimore's racial steering case survived an initial dismissal motion.[255]

Despite the actions of private litigants, a handful of municipal governments and a number of state attorneys general,[256] the federal government has yet to enter into the litigation fray. While the FBI is reportedly pursuing criminal investigations into subprime lending abuses,[257] federal officials have yet to assume a prominent role in pursuing allegations of lending discrimination and steering during the height of the subprime mortgage frenzy.

To the extent that discrimination in lending is a product of social distance, where lenders do not share socioeconomic, ethnic, or racial traits with the borrowers with whom they conduct business, vigorous enforcement of such laws as the Fair Housing Act[258] and the Equal Credit Opportunity Act[259] will help to rein in the potential for discriminatory lending practices. The federal government should take an active and vigorous enforcement role in pursuing allegations of lending discrimination in the subprime mortgage market. Such oversight would send a clear message to the industry and

---

255. Mayor of Baltimore v. Wells Fargo Bank, N.A., No. L-08-62, 2009 WL 1916240, at *1 (D. Md. July 2, 2009); City of Cleveland v. Ameriquest Mortgage Sec., Inc., 621 F. Supp. 2d 513 (N.D. Ohio 2009).

256. One example of state attorney generals' lawsuits targeted at fraud in the subprime mortgage market: last year, Bank of America settled 11 state lawsuits filed against its subsidiary, Countrywide Financial. These cases raised a range of state law claims for fraud and unfair trade practices, though none alleged lending discrimination. For a description of this litigation, see Raymond H. Brescia, *Tainted Loans: The Value of a Mass Torts Approach to Subprime Mortgage Litigation*, 78 U. CINC. L. REV. (forthcoming 2010).

257. *Proposals to Fight Fraud and Protect Taxpayers Before the H. Comm. on the Judiciary* (2009) (testimony of John S. Pistole, Deputy Director, FBI) (describing efforts of the FBI to combat mortgage and other financial frauds).

258. 42 U.S.C. §§ 3601-19 (2006).

259. 15 U.S.C. §§ 1691(a)-1691(f) (2006).

the general public that the government will intervene to prevent social distance from creating a greater likelihood that lenders will engage in discriminatory practices.

Another area in which government intervention could help to reduce social distance is in the area of executive pay. If we are to recognize the effect that social distance can have on rent seeking, the social distance between executives and the general public created by both exorbitant executive pay packages and compensation schemes makes it more likely that executives will, in turn, cheat the public. It also reduces the trust that the general public has in those executives, especially if they are receiving high pay yet inflicting serious harm on the economy. Indeed, there are few issues that have generated as much heat, if not light, in the crisis as the battle over executive compensation.[260] One need not look beyond the outrage generated over the distribution of bonuses at AIG after it was bailed out by the federal government to recognize that this issue is one that, at least during the deepest moments of uncertainty during the crisis, resonated with the American people. While the furor over executive compensation seems to have dissipated somewhat (the news about large bonuses at Goldman Sachs and JP Morgan Chase has not caused much of a stir), the Obama Administration has articulated the need to align executive compensation with long-term incentives, rather than short-term gain, and is proposing ways to make executive compensation schemes more transparent to shareholders.[261]

The question of whether these or other compensation reforms will have any success on Capitol Hill is likely to attract a great deal of attention in the coming months. This is obviously a topic that is of great concern to the financial

260. The New York Post, during the swirling storm over AIG bonuses, ran the following on its cover, in large-type print: "Not So Fast You Greedy Bastards: Feds Plan 100% Tax on AIG Bonuses." N.Y. POST, Mar. 18, 2009.

261. *Obama Plan*, *supra* note 3, at 44-45; *see also* Posting of Jessica Lee to White House Briefing Room Blog, http://www.whitehouse.gov/blog/Accountability-on-Executive-Compensation (June 10, 2009, 15:16 EST) (describing Secretary Geithner's announcement of the Administration's desire for legislation authorizing the SEC to require non-binding shareholder votes on executive compensation) For more information on the executive compensation legislation see U.S. DEP'T OF TREASURY, FACT SHEET: ENSURING INVESTORS HAVE A "SAY ON PAY," http://www.treas.gov/press/releases/reports/fact_sheet_say%20on%20pay.pdf.

industry. There is a strong fear that executive compensation restrictions—whether on firms accepting federal funds through such programs as the Troubled Asset Relief Program or on certain industries generally—will limit the ability of companies subject to such restrictions to recruit the best talent. The Obama Administration's proposals, though relatively weak, may be the strongest types of restrictions that can be imposed politically. In the final part, below, I suggest ways that *voluntary* limits on executive compensation could be proposed that would help lower social distance, both real and perceived, thereby reducing the effect that such social distance can have on rent seeking and the generation of trust, and align long-term interests with present compensation, taking into account repeat-play phenomena.

These and other areas are fertile ground for a broad effort to re-regulate financial markets. The debate over the optimal regulatory approach across a broad range of products and sectors within the financial industry is likely to carry on for months, if not years. Lobbyists for the financial industry are likely to have a significant impact on the final versions of legislation and regulation that comes out of this reform effort, with the most aggressive attempts likely watered down through force of will, time, inertia and gravity. What follows is an attempt to suggest ways that a less contentious process might prove fruitful, and might hew a faster path towards rebuilding trust and trustworthiness than the sausage-making processes of regulatory and legislative reform.

V. HEURISTICS FOR TRUSTWORTHINESS: RETURN OF THE BLUE EAGLE OR THE RISE OF THE BLUE PHOENIX?

There is no question that, to restore trust in the financial system, the regulatory infrastructure needs shoring up in order to fill the legal vacuums in which such instruments like credit default swaps are used and entities like credit rating agencies operate. Will the Financial Crisis Inquiry Commission, created by Congress, help to uncover information about the root causes of the financial crisis to assure the general public that any regulatory structure will respond to the causes of the crisis?[262] Will more robust enforcement of the securities laws and monitoring by bank regulators of financial institution adherence to safety and soundness requirements help to restore faith that the guardians are faithfully executing their duties? There is a desperate and unquestionable need for the creation of an entity like the Consumer Financial Protection Agency, one that will be positioned to assess the merits of the use of exotic financial products and the extent to which other practices might cause harm and increase risk irresponsibly.[263] Yet even with such a consumer advocate in place, it is unlikely that most consumers and investors will be able to process all of the information that the re-regulation effort will generate so that they might be able to use this information to decide whether they can place their faith in financial services providers. But without such faith, on both microeconomic and macroeconomic levels, regulatory efforts designed to restore trust in the financial system will be for naught.

Lay people—prospective home purchasers, individuals investing their retirement savings in 401(k) plans, and individuals trying to determine how to design their investment portfolios—will need mechanisms for assessing the trustworthiness of the financial products and services in which they might wish to place their faith. Individuals inside and outside the Obama Administration are advocating one such effort: the standardization of mortgage products so that mortgage lenders will be required to offer a "plain vanilla" mortgage, one with easy to understand—and fixed—terms. If prospective borrowers wish to pursue more exotic mortgage terms, they will have to make a conscious and explicit decision to opt out of the plain vanilla model. Such a default rule will make mortgage lending simpler, and reduce the risk that lenders will be able to benefit from the limited information borrowers may have about the

262. Stephen Labaton, *A Panel Is Named to Examine Causes of the Economic Crisis*, N.Y. TIMES, July 16, 2009, at B3 (describing creation of the commission and its appointment of members).

263. See *Obama Plan*, *supra* note 3, at 55-62, for a description of the proposed CFPA.

mortgage market in general and mortgage products in particular.[264]

Can we use similar heuristics, or short-cuts, on a broader scale, and in such a way that will give consumers and investors easy-to-process information about the credibility of actors within the financial system and the safety of the products they offer?[265] While a granular analysis of all of the features of the proposed legislation presently before Congress and more that will most certainly be introduced over the coming year, is beyond the scope of this piece, what follows is an effort to introduce a process by which regulators could provide simple, easy-to-understand information to consumers on the practices of the financial services industry: i.e., the extent to which such practices are more likely to make them trustworthy (more on this in a moment). Modeled on voluntary efforts utilized in the New Deal—as opposed to top-down regulatory efforts—the approach presented here would provide financial institutions the regulatory space they need to operate effectively and efficiently, while instilling confidence in their good faith and good will.

During the New Deal, the National Recovery Administration, working with industrial trade associations, developed codes of conduct related to labor practices in a wide range of commercial and manufacturing sectors. Firms that followed these codes were permitted to display a "Blue Eagle" decal in their advertising materials and product labels. Consumers were encouraged to purchase goods manufactured by companies that complied with these voluntary codes.[266] While the codes were criticized severely

264. *See* Barr et al., *supra* note 77 (suggesting that lenders offer simple mortgage product as default option for most borrowers); *see also Obama Plan*, *supra* note 3, at 66-67 (describing proposed regulatory role of encouraging financial institutions to offer consumers simple, easy-to-understand financial products).

265. See Cross, *supra* note 16, at 1510-11, for a description of the application of heuristics.

266. Numerous commentators have discusses the background of the Blue Eagle Program. *See, e.g.*, DAVID EDWIN HARRELL, JR. ET AL., UNTO A GOOD LAND: A HISTORY OF THE AMERICAN PEOPLE 906-07 (2005) (describing the purpose, creation and decline of the 1933 "Blue Eagle" National Recovery Administration program calling on employers to voluntarily limit worker hours and raise minimum wages to help put people to work during the Depression); Erik McKinley Eriksson, *Blue Eagle Emblem in* DICTIONARY OF AMERICAN HISTORY

at the time from many sectors,[267] ultimately, the program was struck down as unconstitutional because Congress, in creating the program, had delegated too much authority to the Executive, and because the codes were found to have an insufficient nexus to interstate commerce.[268]

Yet such a voluntary approach, albeit without the constitutional deficiencies, might be just what the financial system could use at this time. Could regulators utilize these same techniques to give consumers and investors the confidence that financial institutions were following practices that were smart, safe, and designed to instill trust?[269] Reviewing the principles discussed above, could regulators develop a series of codes of conduct for different actors in the financial system that could give the public faith that such individuals and institutions were acting in ways that were more likely to generate trustworthy conduct? Returning to those principles—of regulatory oversight, repeat play, enhanced communication, and reduced social distance: could regulators craft different sets of practices designed with these principles in mind, and then recognize financial institutions when they follow those practices? Such a "seal of approval", whether it was signified by a Blue Eagle or other symbol (a Blue Phoenix, let's say), would give consumers confidence that a particular financial institution was adopting practices that tended to make them more trustworthy.

For example, in the mortgage lending industry, the Federal Reserve or another bank regulator could develop a set of "trust practices" within the industry: practices

---

490 (Stanley I. Kutler ed., 3d ed. 2003) ("All who accepted President Franklin D. Roosevelt's reemployment agreement or the special *Code of Fair Competition* could display a poster that reproduced the blue eagle with the motto 'Member N.R.A. We Do Our Part.'" (emphasis in original)); James G. Pope, *National Industrial Recovery Act (1933) in* 3 MAJOR ACTS OF CONGRESS 31 (Brian K. Landsberg ed., 2004) (describing the "Codes of Fair Competition" and the implementation strategy of the N.R.A. "Blue Eagle" program).

267. MICHAEL J. SANDEL, DEMOCRACY'S DISCONTENT: AMERICA IN SEARCH OF A PUBLIC PHILOSOPHY 253-54 (1998) (recounting criticism).

268. A.L.A. Schecter Poultry Corp. v. United States, 295 U.S. 495 (1935).

269. Due to the interconnected nature of financial products, institutions, and markets, no one would argue that the financial sector does not affect interstate commerce. Similarly, if the codes were truly voluntary, their promotion would not constitute an improper delegation of legislative functions to the Executive.

modeled on the principles of regulatory oversight, repeat play, enhanced communication, and reduced social distance. In that sector, the types of behavior that would likely lend to more untrustworthy behavior would include the following: "originate to securitize" practices, through which lenders do not hold the mortgages they produce, instead selling them on the secondary market, sometimes days or even hours after a loan closes; offering exotic mortgage products, without options for simpler, more straightforward loans; offering no consumer financing other than mortgage financing, reducing the likelihood that such lenders would seek to work with borrowers in other product lines, like savings or checking accounts, or auto loans; compensation practices for executives and mortgage officers that reward quantity of loans over their quality and offer large compensation packages based on short-term profits rather than long-term sustainability; working with brokers that are not acting as the fiduciaries of the borrowers; and the failure to maintain adequate cash reserves to permit the repurchase of underperforming loans that have been sold on the secondary market.

In response, voluntary codes of trust-instilling practices in this sector would include a package of practices that are more likely than not to promote trustworthy behavior. Lending institutions would have to organize themselves in such a way so that they would not escape oversight by appropriate federal and state regulators (and the Federal Reserve could even approve the oversight system of each state, and confirm whether it has a robust and effective state regulatory structure and capacity).[270] Such institutions would have to certify that they were not engaged in practices that were largely outside the law, like offering pay-day loans, and would have to offer the types of plain vanilla mortgage products discussed above. Similarly, they would have to offer a range of consumer products, or

270. Such an approach would be consistent with practices in the environmental context under the Clean Air Act, 42 U.S.C. §§ 7401-7671(g) (2006), and Clean Water Act, 33 U.S.C. §§ 1251-1387 (2006) in which the states are the primary regulators, subject to federal approval of their oversight structure and practices. *See, e.g.*, 42 U.S.C. § 7661(b)(4) (requiring adequate personnel and funding to administer the permit program); 42 U.S.C. § 7661(a)(d)(3) (authorizing Environmental Protection Agency to administer permit program within states in which the EPA has not approved a state program for same).

affiliate with financial institutions that did, to show that they were at least interested in a range of business relations with their prospective mortgage customers. They would warrant that they would only work with brokers that acted as fiduciaries towards the borrowers with which they work and followed compensation practices that aligned the interest of employees with the long-term stability and viability of the lending practices of the institution. Furthermore, institutions would voluntarily adopt executive compensation packages that would reduce, rather than increase, social distance between the customers of the institution and its leaders. Finally, to the extent that they were packaging and attempting to securitize the mortgages they generate, or engaging in similar, yet to be devised practices, they would have to maintain a portion of these loans on their own books, as well as reserves to cover the cost of any loans that would have to be repurchased for nonperformance.[271]

The regulatory agency responsible for overseeing mortgage lending would authorize mortgage lenders that follow these practices to display the Blue Phoenix in their marketing materials, websites, and anywhere else they choose. Just as consumers might look for "the union label" or the Good Housekeeping "seal of approval," the sign of the Blue Phoenix would send a message to prospective customers that the lender was engaging in a range of practices that tend to make it more trustworthy rather than less.[272] It would also send that message to investors that might be interested in purchasing on the secondary market the loans the lender generated.

With a marketing effort that emphasized the importance of trust-producing practices and the significance of the Blue Phoenix, it is likely that the market would generate significant support for firms that followed the voluntary codes of conduct.

---

271. This concept, known as "skin in the game," is one of the proposals of the Obama Plan; mortgage loan securitizers would be required to maintain on their books 5% of the loans they package to be sold on the securitization market. *See Obama Plan*, *supra* note 3, at 44.

272. On the use of heuristics in the political realm, see Heather K. Gerken, *Shortcuts to Reform*, 93 MINN. L. REV. 1582 (2009) for a description of party affiliation of candidates as a heuristic on which voters rely.

The codes themselves would be fine tuned for each industry, and crafted through an open dialogue between regulators, elected officials, industry representatives, and consumer advocates. One could envision such a package of practices designed for each industry: e.g., credit rating agencies that act as fiduciaries towards those who rely on the ratings information they generate; and companies that issue credit default swaps or their equivalent agreeing to subject themselves to oversight by insurance regulators. At this juncture, the point is not to establish an exhaustive list of trust-generating practices for every industry in which the codes would be relevant. Rather, my goal here is simple: to introduce the concept of voluntary codes of conduct for financial institution practices generally, where compliance with such codes could be communicated through the use of a heuristic symbol. That symbol would, in turn, become a shorthand for a wealth of information valuable to consumers and could serve to assist the general public in making decisions about a host of financial industry practices, in a range of settings.

Such a use of heuristics would generate more confidence from the general public in the financial sector than thousands of pages of legislation and regulation could ever produce. It is unlikely that consumers and investors are willing or able to dedicate the time to educate themselves on the optimal package of regulatory or legislative changes needed to shore up the oversight regime, nor would most people have the expertise to make informed decisions about complex financial industry practices. Without the capacity to make such decisions, to the extent that re-regulation does generate trust, it is more likely to be the affective kind—more based on a feeling than on a sober assessment of the best blend of reformed financial practices and strengthened oversight. The use of a heuristic that communicates a range of information to the general public would take into account the limits of human capacity when making decisions requiring a complex web of information and expertise.

Make no mistake, such voluntary codes of conduct would not serve as a substitute for vigorous enforcement of anti-discrimination laws, anti-trust laws, anti-fraud laws, and criminal codes, or for legislation reining in credit default swaps and other aspects of the shadow banking system. Rather, this voluntary regime would broach some of the more contentious issues, like executive compensation, where the correct role of regulation is subject to heated debate, and correctly so. Furthermore, such a "light touch" regime would act like a cooperative first move in a prisoner dilemma game; regulators would signal an opening, cooperative move by attempting to induce firms to adopt trust-generating practices. As we know from game theory, such first moves are likely to be mirrored by the game partner. This first move would be coupled by regulators cutting firms that adopt such practices a wide berth, while ensuring vigorous enforcement of clear cut prohibitions, like those against discrimination in lending and securities fraud.[273] By making a range of conduct voluntary and with clear rewards for voluntary compliance that will likely generate strong market share, it is likely that such practices will become the norm, and not the exception.

---

273. *See e.g.*, IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 35-41 (1992) (advocating that regulators must have strong sanctions—a "benign big gun"—that makes lighter regulatory approaches possible); Christine Parker, *Reinventing Regulation Within the Corporation: Compliance-Oriented Regulatory Innovation*, 32 ADMIN. & SOC'Y 529, 533-35 (2000) (recognizing the role of credible enforcement in making lighter touch regulation possible). The process of developing the voluntary codes could itself serve valuable ends, and develop a more cooperative relationship between the representatives of the financial industry, regulators, and consumer advocates:

> While stressing the continued need for an active public role, however, the "new governance" acknowledges that command and control are not the appropriate administrative approach in the world of network relationships that increasingly exists. Given the pervasive interdependence that characterizes such networks, no entity, including the state, is in a position to enforce its will on the others over the long run. In these circumstances, *negotiation and persuasion* replace command and control as the preferred management approach, not only in the setting of policy but in carrying it out. Instead of issuing orders, public managers must learn how to create incentives for the outcomes they desire from actors over whom they have only imperfect control. Indeed, negotiation is even necessary over the *goals* that public action is to serve since part of the reason that third parties are often cut into the operation of public programs is that such clarity cannot be achieved at the point of enactment.

Lester M. Salamon, *The New Governance and the Tools of Public Action: An Introduction*, 28 FORDHAM URB. L.J. 1611, 1635-36 (2001) (footnote omitted).

CONCLUSION

The forces that drive people to trust and to be trustworthy are complex, varied, external, and internal. The optimal alignment of these forces that will encourage both trusting and trustworthy behavior, while discouraging their opposites, is often elusive, which does not mean that balance should not be sought. The Obama Administration, regulators, legislators, financial services providers, and consumers all have a large stake in restoring trust to the financial system. Doing so is critical not just to speed the recovery, but also to prevent the next crisis. It is respectfully submitted that some of the principles discussed here could help inform these efforts, by shedding light on the forces that could generate both trust *and* trustworthiness. Both are essential to this endeavor.